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Polish Weekly Review

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Comment on the upcoming data and forecasts

The week kicks in with PMI data for January. We expect a slight improvement in business sentiment, which is consistent with relatively low momentum in Polish economy. It is worth highlighting that both German data as well as CSO indicators show no signs of change in sentiment. The MPC meeting ends on Wednesday. Although there are many arguments in favour of resuming cuts in March (deciding on the basis of new inflation projection, still high volatility on foreign exchange markets, good industrial production data for December), one cannot rule out that cuts will start yet in February. Reasons for that are already there: low momentum in Polish economy, clear and present risks to Polish growth and significant deviation from the inflation target (inflation still dropping like a rock).

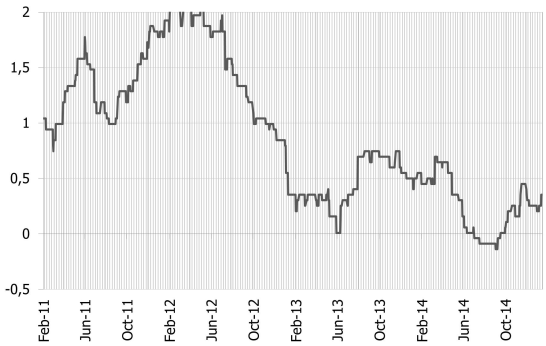
Polish data to watch: February 2nd to February 6th

Publication	Date	Period	mBank	Consensus	Prior
Manufacturing PMI	02.02	Jan	53.5	53.1	52.8
MPC decision (%)	04.02	Feb	1.75	2.00	2.00

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 OK0717	2/12/2015	2000	1.653	1/22/2015
5Y T-bond PS0720	2/12/2015	3000	2.007	1/22/2015
10Y T-bond DS1025	2/5/2015	1500	2.295	1/15/2015
20Y T-bond WS0429	2/5/2015	500	2.308	1/15/2015

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



Comment

Big positive surprise in unemployment data and our surprise index increased on a weekly basis, yet it remains flat over the past several weeks. Next week brings only one opportunity for surprise - the PMI.

* 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

- 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 negative and strengthens the impact of high real interest rates. GDP growth is too low to close output gap. Inflation is going to stay low.
- 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.
- Zloty to strenghten in the mid-term on euro QE and high real interest rates (carry trades).

mBank forecasts

	2010	2011	2012	2013	2014	2015F
GDP y/y (%)	3.7	4.8	1.8	1.7	3.3	3.5
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	-0.1	-0.6
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	10.3
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	3.1	2.8	3.1	3.5	4.4
Individual consumption y/y (%)	2.9	3.0	3.2	2.9	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	8.8	6.0	6.0	7.0	9.0
Inflation rate (% average)	0.6	0.2	-0.3	-0.7	-1.4	-0.9	-0.4	0.5
Unemployment rate (% eop)	13.9	12.0	11.5	11.5	12.1	11.0	10.2	10.3
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	1.50	1.50	1.55	1.65
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	1.80	1.80	2.30	2.60
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.25	4.20	4.15	4.10
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.66	3.68	3.84	3.90

F - forecast

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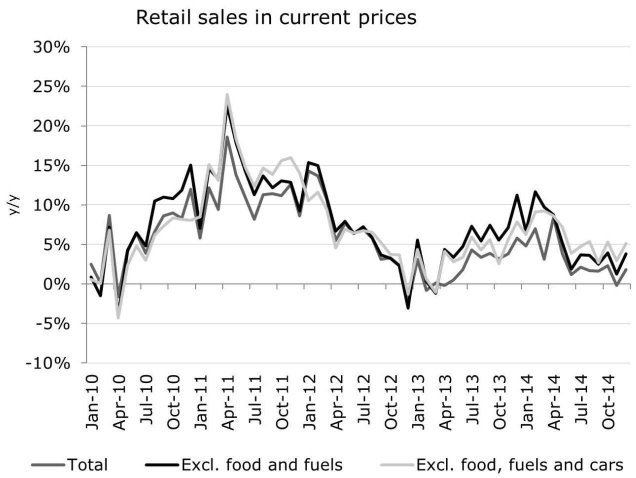
Economics

Retail sales accelerated but with poor growth composition

Retail sales grew in December by 1.8% compared to -0.2% last month. This value was more less in line with consensus and slightly higher than our forecast. The structure remained weak. The acceleration resulted from a small rebound in car sales (slight positive deviation from seasonal patterns is most likely just noise) and much higher food sales, which is always subjected to such gyrations in December, that it is very hard to predict its exact value. On the other hand, durable goods performed extremely poorly (from +3.7% they fell suddenly to -3.3%). This is not the best composition to draw further conclusions about rebound in goods sales. Similar horizontal-like pattern occurs also in categories after exclusions (see the graph below).

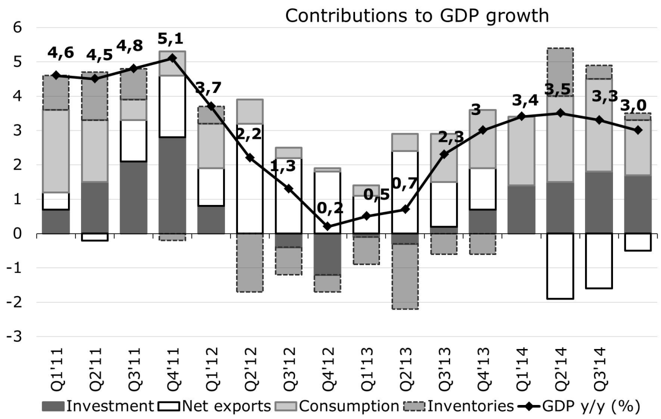


Private consumption dynamics reveals that consumption of goods is secondary factor comparing to services, which perform fine because of strong labour market. We do not see any reversion in this trend. Prices of retail sales continue to fall and they can cause some positive demand effects in following months in goods sales. However, those cannot be seen yet.

Annual GDP release confirms our expectations of slight slowdown at the turn of the year

Meanwhile, aggregate data point out to a slight slowdown at the turn of the year. Granted, GDP grew by an impressive 3.3% in 2014, accelerating from 1.7% recorded in 2013, but the most interesting information we can draw from annual GDP estimates is the possibility of calculating Q4 growth few weeks before the flash release of quarterly GDP. According to our calculations, GDP growth fell from 3.3% in Q3 to ca. 3% (or even slightly below) in the fourth quarter. It confirms our expectations that yoy growth rates will bottom out at the turn of the year (2014Q4 and 2015Q1), thus ending the soft patch.

Annual figures provided by GUS suggest that Q4 GDP was brought down by slowing consumption (from 3.2% to ca. 2.9% y/y) and investment (from 9.9% to 8.8%). The former could have flatten out because of higher savings rate and lack of further acceleration in demand for consumer services. We already know that real retail sales remained flat in Q4. Investment growth, on the other hand, remained strong. We still do not know the breakdown of investment by asset types for the past releases but if previous quarters are any guide, we can at least claim that public investment contributed strongly.



Economic activity is subject to downside risks in the short-term: slower exports growth to Russia, uncertainty shock cast by CHFPLN increase. Those risks are unlikely to derail the cycle, though. Next quarters are expected to bring stable consumption growth, supported by the development in the labor market, low fuel prices and positive income effects stemming from deflation. 2015 should also bring decent growth in investment activity, supported by infrastructure demand in late 2015.

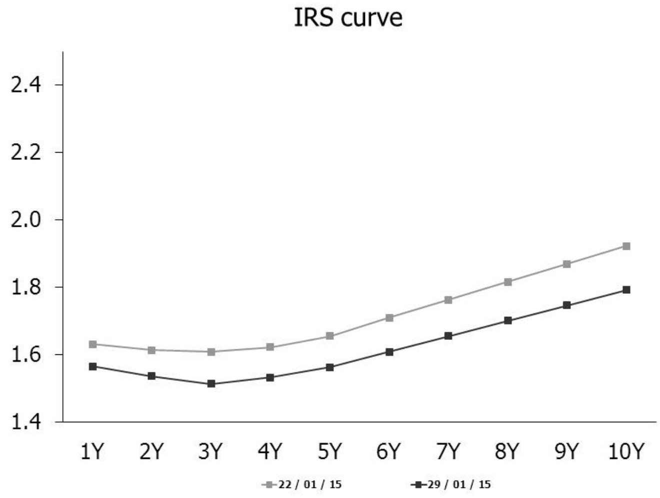
Ongoing data publications and expected minimum in GDP growth at the turn of 2014 and 2015 are set to be supportive for monetary easing. We still think that the room for at least 50bp of rate cuts is made by deepening and prolonged deflation and the risk of zloty strengthening amid euro zone's QE.

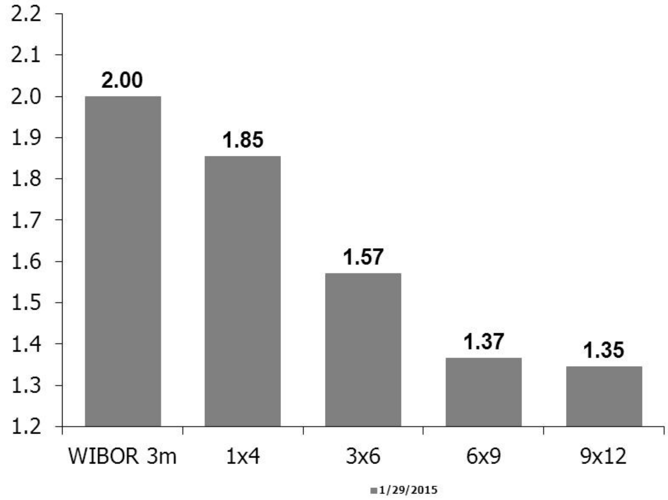
Fixed income

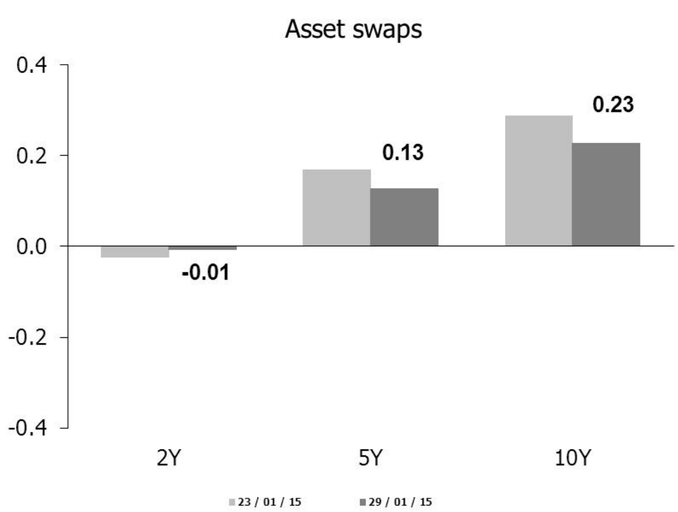
What to do...

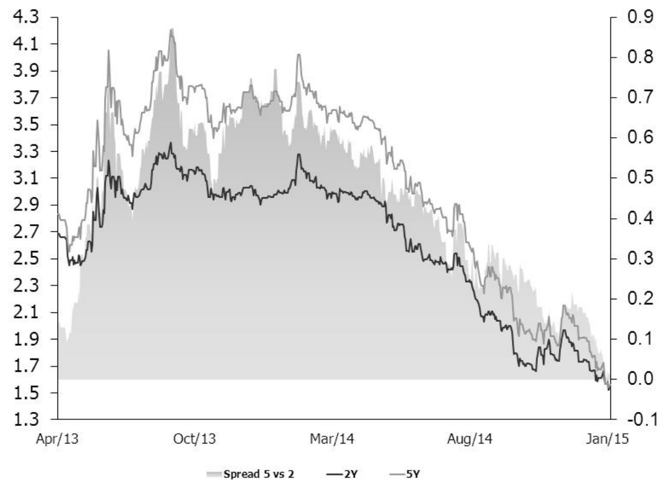
...with all that money? Polish fixed income market witnessed another wave of massive inflows into PolGBs. With ECB planning QE, dovish Fed statements and global cash overliquidity our yields broke new barriers. PS0719 reached 1.65%, DS0725 1,97%. It seems that foreign investors were 'forced' to buy Polish bonds. For local clients PolGBs are extremely expensive currently.

Demand for long end bonds should be filled (at least temporarily) on next two auctions (5th and 12th Feb). Rally on fixed income market should take a few weeks break as we don't expect new positive information and there is a lot of bonds 'in profit' on the market now.







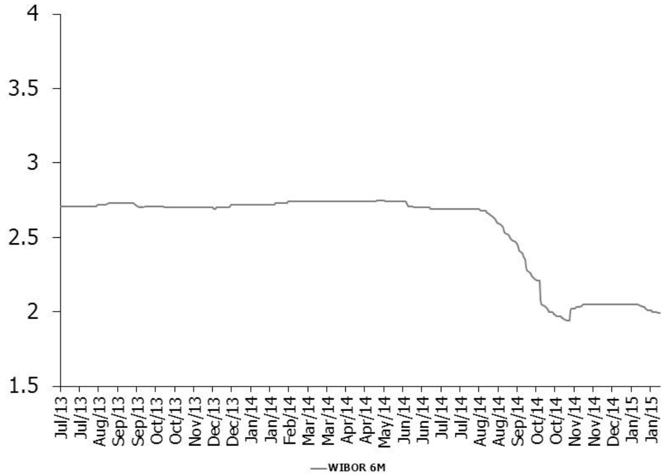


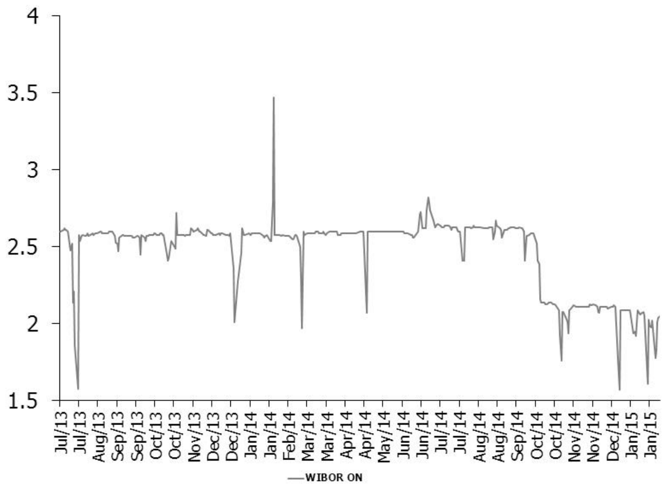
Money market

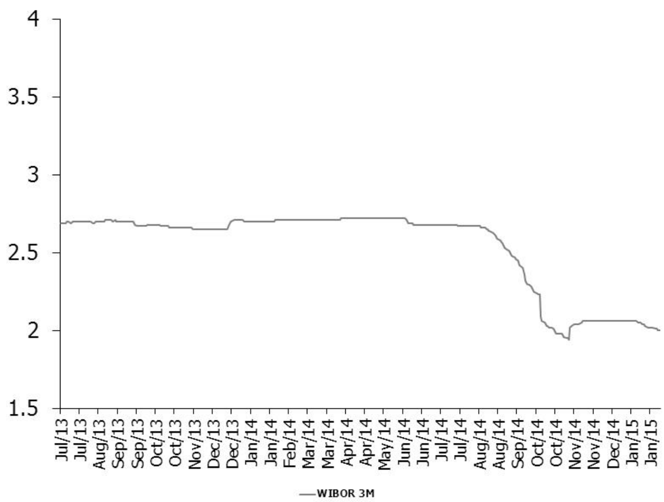
Interesting week behind us

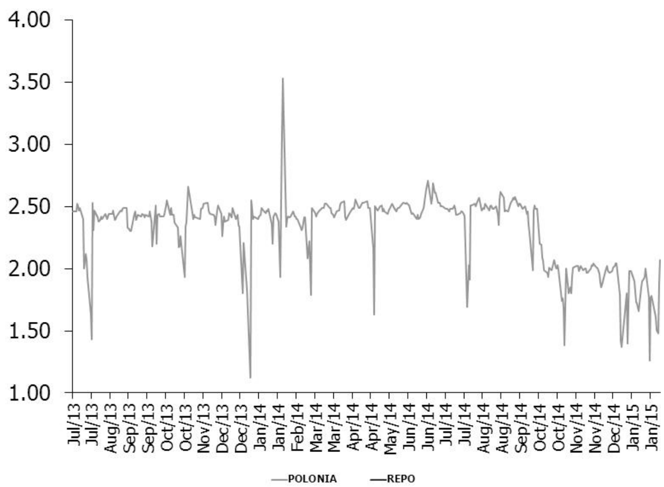
As last Friday's OMO was underbid, the beginning of the week was very cheap with cash around 1.50. Additional OMO on Wednesday moved Polonia to 1.88 and 2.07 on Tuesday.

The shortest rates moved down by 7-9 bps. 1Y OIS is now 1.35/1.40, discounting almost 75 bps rate cuts until September. Next week we have MPC meeting with 50% probability of 25bps rate cut discounted in 1M OIS. OK0116 with yield at 1.55 still looks very attractive comparing to FRA rates (3x6 at 1.55 and 9x12 at 1.34).









Forex

Choppy in range Last Friday, in the afternoon, we observed an enormous PLN buying flow, which took EUR/PLN from its highs (4.335 two days earlier) to 4.1950 lows. There was some buying interest from the lows and we came back to above the 4.25 after the FOMC meeting, only to drop to 4.2050 level during next few hours.

PLN is supported by QE launched by the ECB as well as the rebound in EUR/CHF (it is an immediate benefit to the Polish economy). But while the Fed is still on a normalization path, and the fact that our MPC is more dovish and we can see rate cuts this quarter, as well as Greece's, Ukraine's and Russia's problems are hanging over us, the demand for PLN will probably fizzle out. The realized volatility is significantly higher, but is it enough to break out of the current 4.20 / 4.30 range?

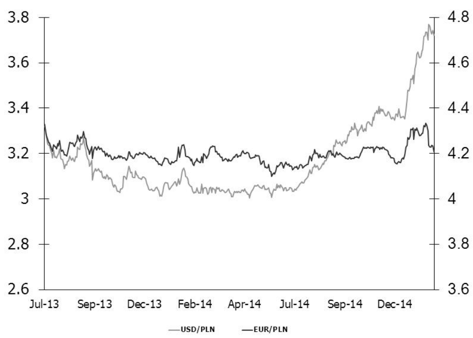
Vols - volatility curve flattener (with front end higher) The gamma was really in demand last time, and all those who have paid for Gamma should not be disappointed. 1w atm is at 9.25% (1.75% higher than a week ago), 1m realized volatility jumped to 10% (a month ago it was barely 4%). Because of so high realized volatility the correlation: stronger PLN - lower volatility doesn't work anymore. EURPLN volatility curve for tenors 1M-1Y is flat at around 7.8% mid - it is approximately the same as a week ago. The skew was rather unchanged.

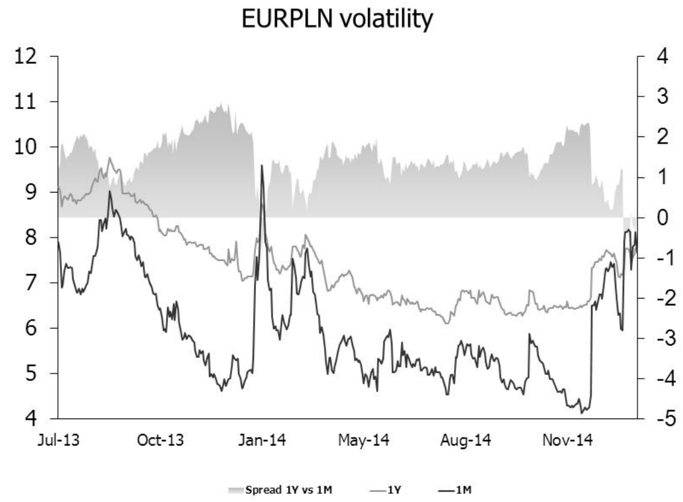
Short-term forecasts

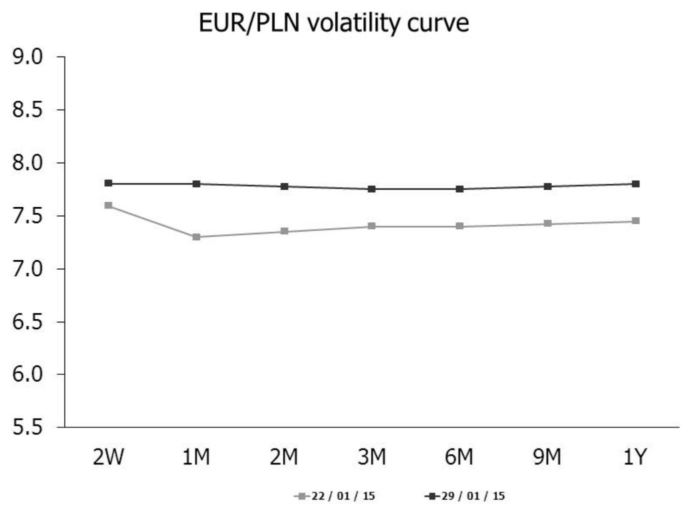
Main supports / resistances:
EUR/PLN: 4.1950 / 4.3150
USD/PLN: 3.6000 / 3.9000

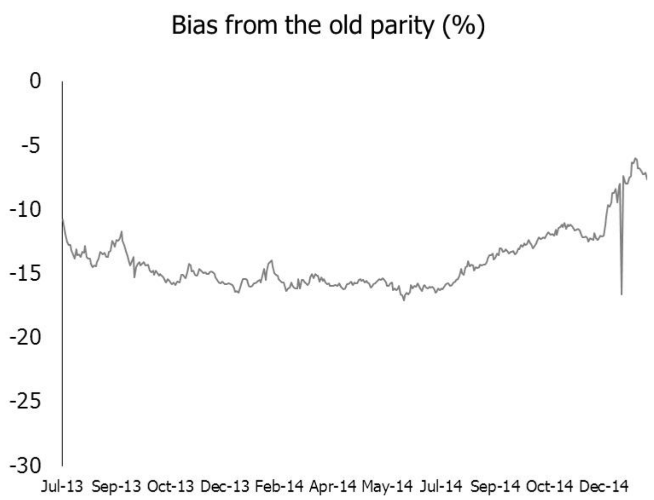
Spot – long EUR/PLN at 4.2050 We closed our longs (opened at 4.3380) at 4.25 on Thursday in the morning, only to re-enter some hours later again at 4.2050. We have a stop below 4.1930 and will take profit at 4.25. The bigger picture favors a 4.20 - 4.30 range for EUR/PLN.

Options – Selective short vega Although realized volatility has picked up nicely, we have ventured to sell some mid term vega. We expect the vols to go even lower when spot stabilizes and theta bills would get a bit more painful. All we need are a few days of relative calmness and we should see vols melting. We think the levels to buy are 6.8% 6 months EUR/PLN and 7.2% 1 year. Nevertheless, it looks like the vols market is back to life.









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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
1/23/2015	1.92	2.02	1.92	1.90	1.90	1.90	1.86	1.63	1.41	1.39	1.42	1.41
1/26/2015	1.92	2.01	1.90	1.90	1.90	1.89	1.88	1.60	1.41	1.39	1.42	1.41
1/27/2015	1.92	2.01	1.90	1.90	1.90	1.89	1.86	1.55	1.35	1.32	1.32	1.36
1/28/2015	1.67	2.00	1.57	1.89	1.60	1.88	1.87	1.60	1.38	1.35	1.35	1.38
1/29/2015	1.77	2.00	1.68	1.89	1.68	1.88	1.85	1.57	1.37	1.35	1.35	1.38

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
1/23/2015	1.900	1.645	1.565	1.541	1.570	1.738	1.810	2.098
1/26/2015	1.890	1.638	1.575	1.571	1.595	1.761	1.815	2.098
1/27/2015	1.890	1.570	1.525	1.522	1.540	1.681	1.762	2.019
1/28/2015	1.880	1.606	1.540	1.540	1.552	1.695	1.785	2.017
1/29/2015	1.880	1.556	1.535	1.529	1.562	1.689	1.792	2.019

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
1/23/2015	7.80	7.60	7.55	7.58	7.58	2.55	0.69
1/26/2015	7.85	7.63	7.63	7.64	7.64	2.55	0.69
1/27/2015	8.13	7.75	7.70	7.76	7.76	2.50	0.67
1/28/2015	7.68	7.60	7.65	7.73	7.73	2.50	0.66
1/29/2015	7.80	7.75	7.75	7.80	7.80	2.55	0.75

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/23/2015	4.2354	3.7687	4.3223	3.1834	1.3601	0.1522
1/26/2015	4.2293	3.7601	4.2448	3.1824	1.3569	0.1524
1/27/2015	4.2285	3.7348	4.1357	3.1624	1.3527	0.1523
1/28/2015	4.2348	3.7276	4.1335	3.1636	1.3600	0.1521
1/29/2015	4.2344	3.7418	4.1007	3.1756	1.3569	0.1524

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