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Polish Weekly Review

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Comment on the upcoming data and forecasts

We start the series of macroeconomic data releases for February on Friday, with inflation and M3 data. We expect CPI to fall in February to -1.4%, which is caused by a moderate decline in food prices and another monthly fall in fuel prices (mainly LPG). Main risk factors for our forecast are: change of basket used by CSO and revision of Januarys release in our opinion there is a possible revision from -1.3 to -1.2%. Acceleration of M3 growth results from strong growth of cash in circulation and low statistical base in some categories (nonmonetary financial institutions' deposits and other M3 components).

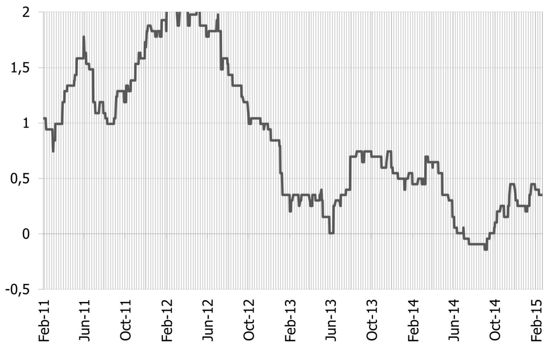
Polish data to watch: March 9th to March 13th

Publication	Date	Period	mBank	Consensus	Prior
CPI yoy (%)	13.03	Feb	-1.4	-1.4	-1.3
M3 yoy (%)	13.03	Feb	9.0	8.6	8.5

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 OK0717	-	1500	1.667	2/12/2015
5Y T-bond PS0720	-	3500	1.987	2/12/2015
10Y T-bond DS0725	3/12/2015	1500	2.295	2/5/2015
20Y T-bond WS0428	3/12/2015	500	2.308	2/5/2015

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



Comment

No surprises - the PMI came out only slightly above expectations. Next week brings one opportunity for surprise - the CPI release. In our view, it is likely that it will surprise to the upside.

* 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% and we are close to the bottom in terms of annual growth rate.
- 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 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.
- Momentum of inflation recorded a turnaround and we await higher readings in coming months. However, GDP gap is too wide to generate inflation pressure and therefore inflation is going to stay low (very low).
- MPC did its part delivering 50bps cut in March. Official communication states that the cycle has been concluded and rates are going to stay at 1.5%. At the same time rate hikes are miles away since there is no inflation in sight and the new MPC (starting job in 2016) may be even more dovish.

Financial markets

- We closed our long position in 10y sector and turned neutral/negative.
- MPC concluded the easing cycle at 1.5% and rate cut expectations can only be fueled by substantial PLN strengthening due to QE-connected inflows, high real interest rates and improving cyclical position of the Polish economy.
- Therefore short-end bonds are set to correlate well with EURPLN.
- Local story is exhausted with regard to Polish long term bonds. From now on focus shifts to euro zone's reflation trends (higher breakevens, higher swap rates amid credit risk compression in the periphery) and whether or not Fed will normalize rates.

mBank forecasts

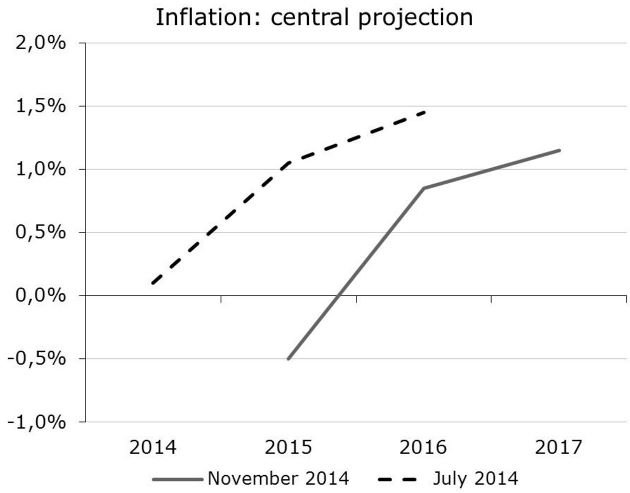
	2010	2011	2012	2013	2014	2015F
GDP y/y (%)	3.7	4.8	1.8	1.7	3.3	3.5
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	-0.1	-0.6
Current account (%GDP)	-4.5	-4.9	-3.5	-1.3	-1.2	-1.8
Unemployment rate (end of period %)	12.4	12.5	13.4	13.4	11.5	10.3
Repo rate (end of period %)	3.50	4.50	4.25	2.50	2.00	1.50

	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1 F	2015 Q2 F	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	3.1	2.8	2.8	3.2	3.4
Public Consumption y/y (%)	0.1	3.7	3.5	3.7	2.0	3.0	3.0	3.0
Investment y/y (%)	11.2	8.7	9.9	9.0	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	1.55	1.55	1.55	1.55
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.20	2.20	2.30	2.50
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.10	4.05	4.00	4.00
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.66	3.68	3.70	3.81

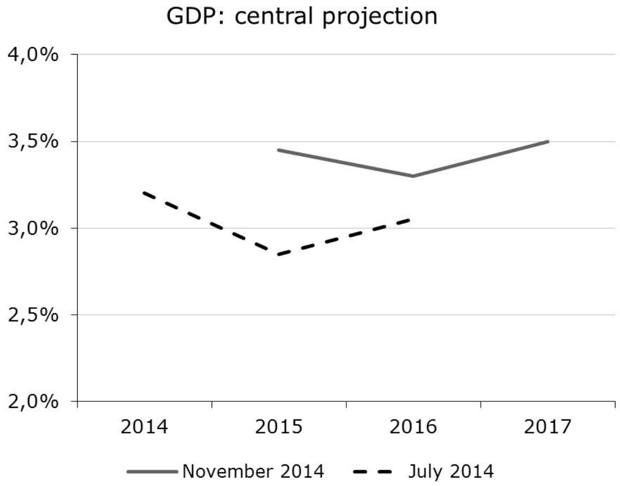
F - forecast

MPC cut rates by 50bp and announces the end of the easing cycle

Just as we have predicted the MPC cut interest rates by 50bp (similar to 2013) announcing the end of the easing cycle at the same time. This was quite a surprise (for analysts) because most of them expected the cuts to be delivered in 25bps clips (as advocated by some MPC members). Investors did not expect such a clear statement in the information from the meeting: "Decision to lower the interest rates at the current meeting concludes the monetary easing cycle". Such a rigid (and risky, taking into account possible turbulences in macroeconomic environment) declaration is obviously the price of a compromise reached with more hawkish MPC members (decision was probably made by a vast majority). Governor Belka was firmly defending this statement during the press conference (we saw it as another condition for compromise), suggesting further decisions about rates or changes in wording will be left to the next Council. Furthermore, the decision to end the monetary easing cycle was made despite the fact that inflation is projected to remain below target throughout the projection window (until 2017).



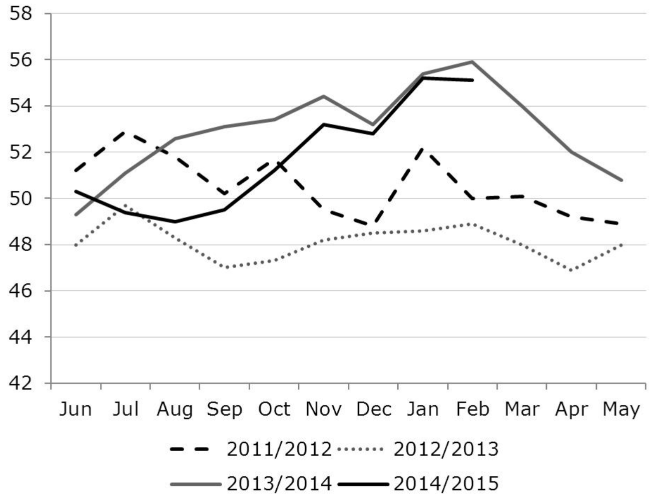
What's next? The main factor (despite governors announcement) shaping expectations for further MPC activities will be the PLN exchange rate. We think that there could still be pressure on strengthening of the Zloty. The way to further rate cuts will be a long one, whilst NBP (as stated by Belka during the conference) will first intervene on the foreign exchange market. In the short term expectations for further cuts will be mitigated by improving economic conditions and inflation rebounding from its minima (in both Poland and Europe). Investors could temporarily believe in the so called reflation and abandon expectations for further rate cuts in Poland. New projections goes along with our scenario of sustained acceleration of economic growth in Poland (see chart below). At the same time we are very sceptical towards rate hikes in Poland. New MPC could be even more tolerant of inflation than the present one.



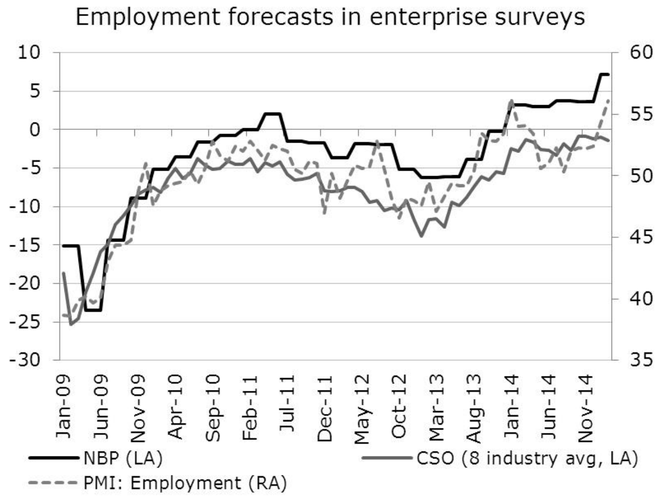
When it comes to the bond market, local factors (in relation to MPC announcement) are being put aside. Most important factor is now the reflation trade in Europe (economic revival and optimistic inflation expectations regarding the next several years) but also good economic situation in USA and policy normalization by the Fed. This constellation is looking grim for Polish bonds.

PMI unchanged, Polish economy enters new year with sustained momentum

According to PMI data released on Monday, Polish industry sustained in February its solid momentum - index remained at previous month's level (55.1 vs 55.2 in January). Just as one year ago PMI shows strong dynamic in the first months of the year. Different to the previous year, there are no factors in sight (Ukraine and Russia) that could temporarily derail the recovery.



PMI structure remains solid. Comparing to January, there is a slight slowdown in the pace of both output growth (from 57.6 do 56.8) and new orders (from 57.2 do 56.4). When it comes to the latter category, the slide was due to a deterioration of export orders. This was linked by some of the surveyed to the lack of demand on Ukrainian and Russian market (maybe a second wave of recession on eastern markets?). We estimate that domestic orders remained the same as in the previous month. February's employment index (56.1) was only few decimals lower than its all time high (56.3 in January 2014). This confirms the signal from NBP's quarterly survey of enterprises, which indicated rapid improvement of employment forecasts for Q1 2015. It is worth mentioning that we do not find this pattern in CSO surveys (see chart below), but even those most pessimistic surveys suggest that Polish labour market is in much better shape than in 2010 – 2011.



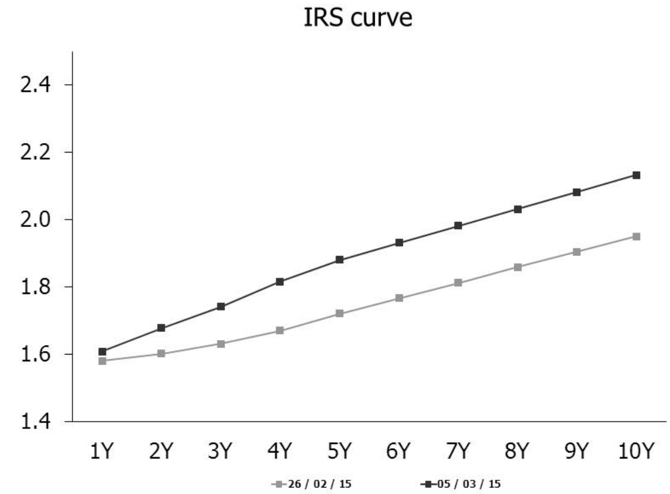
To keep it clear, February's PMI shows no signs of ending disinflational tendencies - costs of production remain unchanged for the next month in a row (weaker exchange rate and higher food prices mentioned by surveyed were not able to change this situation), whilst finished goods prices continued falling for the 32th month in a row! We need to keep in mind that manufactured goods are such a small part of consumers' baskets that they will not stop incoming reversion of falling inflation just as they have not caused it in the first place.

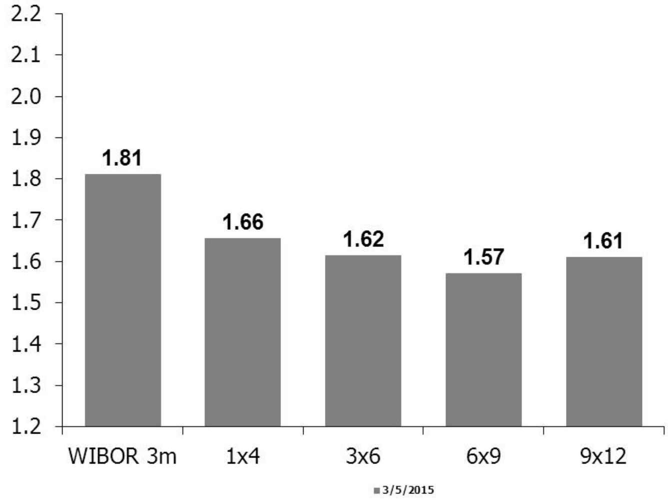
Fixed income

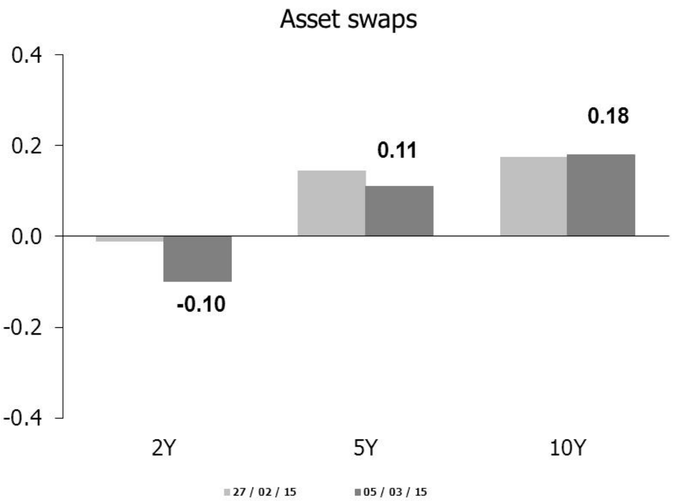
End of the 'cycle'

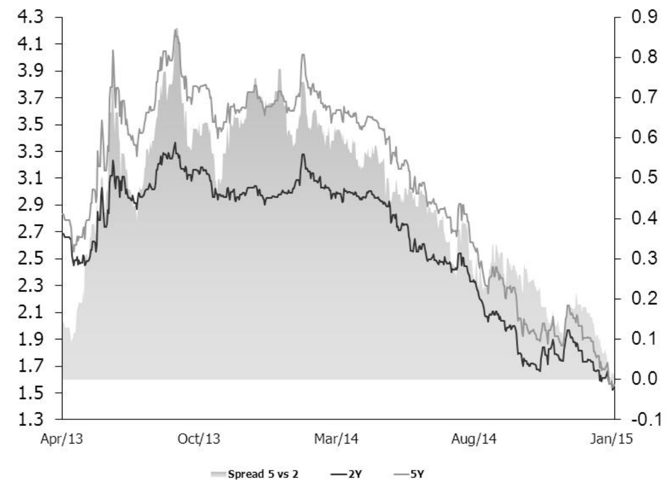
We had another very busy week on the fixed income market. The MPC surprised not only with the scale of the rate cut (50bps instead of 25bps) but also with a strong 'no further cuts' statement. It was quite a disappointment for fixed income traders as they expected this 'cut one more time' game to last till the end of 2015. It seems that the 'rate cut' opportunity window has closed rapidly and we are focusing on foreign markets now. And there is much to focus at, as Mr. Draghi announced details of QE (and caused 10bp Bund rally). At the end of the week strong data from US economy pushed yields of 10y PolGBs up to 2 month high of 2.40%.

With yields going higher on all markets except of those unnaturally pushed low (like in Euroland) we recommend to close all long PolGBs positions above 2Y (if you haven't already).









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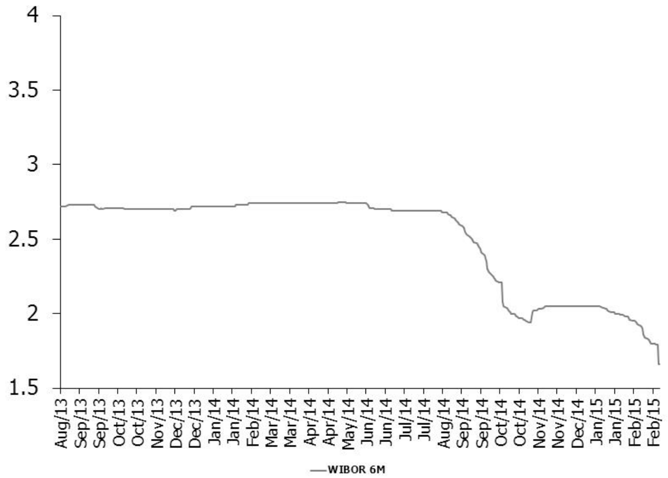
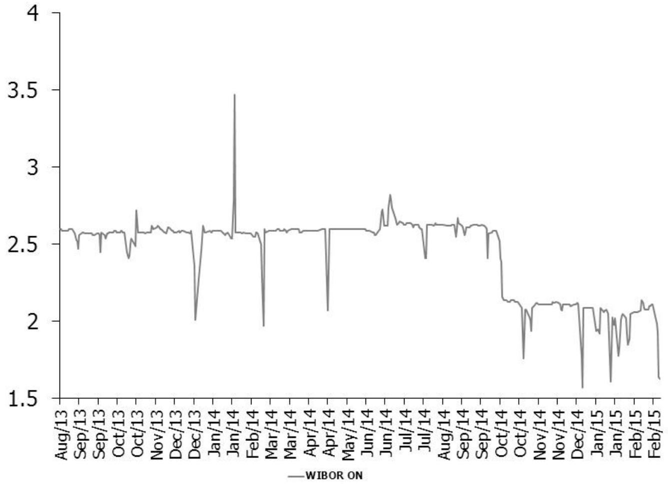
Money market

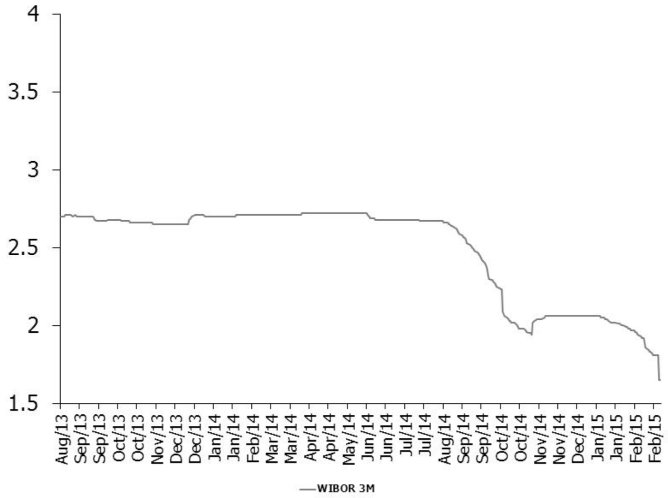
Surprise cut from the MPC moved short rates

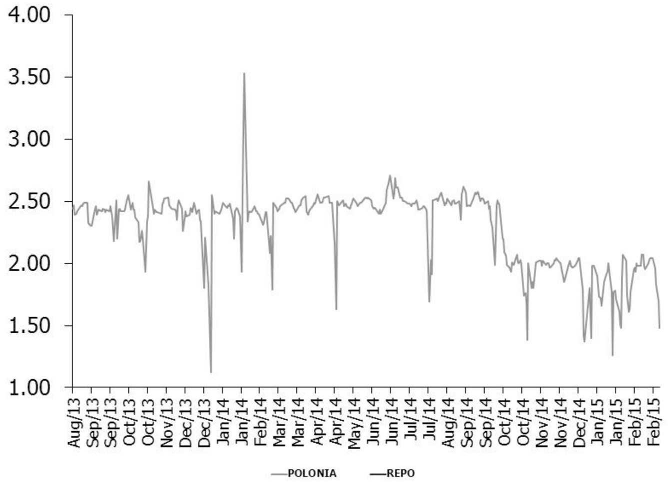
Before the MPC decision cash rates fell to potential new reference rate and Polonia fluctuated around 1.80. After the unexpected 50 bps rate cut rates fell to 1.48. Surprisingly, the only receive position which gained profits were 1x4 FRA and shortest OIS.

As Mr Belka announced the end of cycle 1Y OIS is now 1.40-1.45. Our spread 9x12 vs 1Y OIS is now around 20 bps witch is highest since April 2014. We suggest selling that as just 1W a go it was flat. OK0116 is still on the offer so BUY it at 1.56 with no risk.





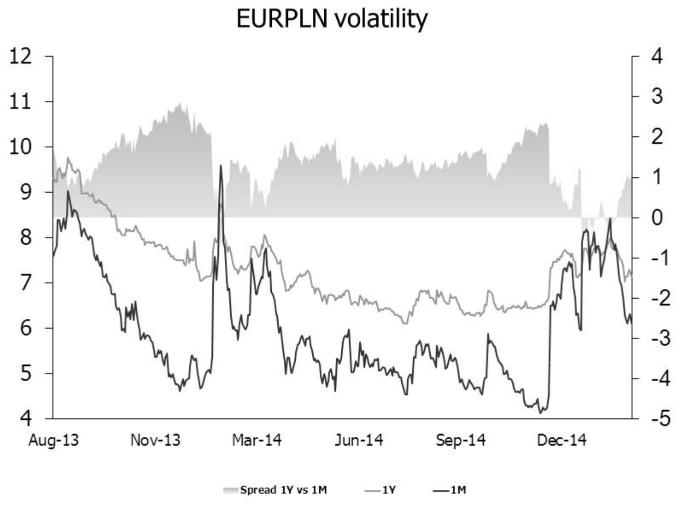




Forex

PLN at year's highs Even bigger than expected MPC rate cut (by 50bps) was not enough to weaken the PLN, as the market has chosen to put faith in Central Bank Head's words that current rates levels are written in stone. As a result EUR/PLN managed to break decisively the 4.15 support, and set fresh lows 4.1160 (last seen in July 2014). We are now testing the multi week lows, the 4.08/4.10 support zone is looming at the horizon, and it will be much tougher to crack. We haven't abandoned our market view on the range nature of EUR/PLN . But the range is maybe shifting lower. . .

Options – Vols melting Stronger PLN was the main reason behind Vols melting process. We are heading south with both our main currency pairs, EUR/PLN and USD/PLN, especially in the frontend. 1 month EUR/PLN ATM mid is fixing this Friday at 5.6% (0.4% lower), 3 months EUR/PLN are 6.2% (0.1% lower), and finally 1 year is 7.1% (unchanged). The skew was also heavily offered, with the whole curve shifting by roughly 0.25%. The currency spread (difference between USD/PLN and EUR/PLN) was also better offered due to more positively correlated EUR/USD and EUR/PLN.

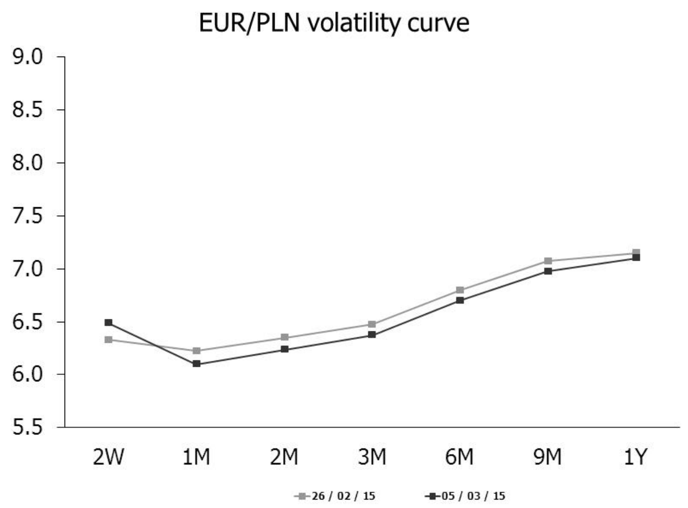


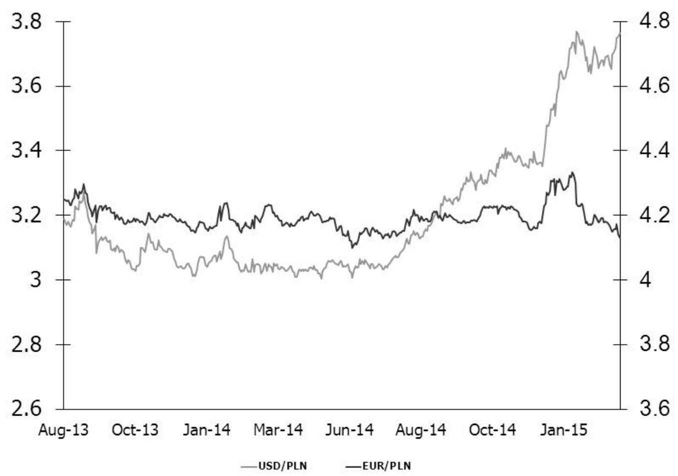
Short-term forecasts

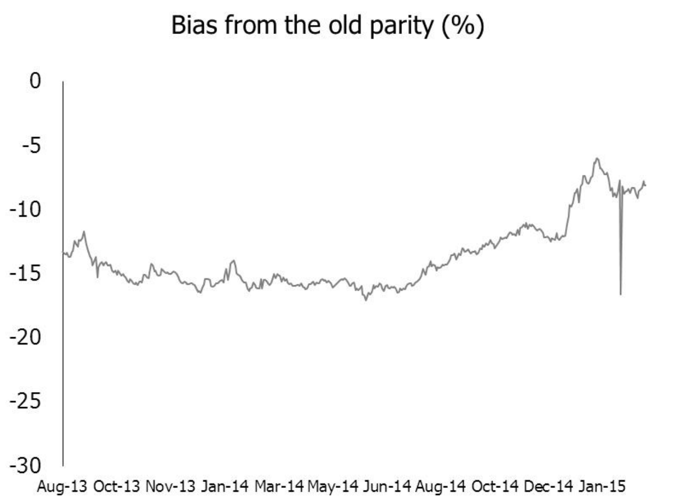
Main supports / resistances:
EUR/PLN: 4.08 / 4.24
USD/PLN: 3.60 / 3.90

Spot EUR/PLN long from 4.1575 stopped at 4.1350. Side-lined at the moment.

Options We are long Vega in the backend. We are also at bids in the mid curve 3m-6m, and we are trying to be long Vega in both EUR/PLN and USD/PLN. We think current sell off in Vols is mostly due to PLN strength. It's a little knee jerk reaction, as realized vols are still quite supportive for long Vol positons.







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
2/27/2015	1.75	1.81	1.71	1.70	1.81	1.69	1.70	1.56	1.48	1.52	1.53	1.52
3/2/2015	1.82	1.81	1.81	1.70	1.66	1.69	1.70	1.56	1.50	1.51	1.52	1.51
3/3/2015	1.84	1.81	1.82	1.69	1.93	1.69	1.72	1.59	1.53	1.56	1.57	1.54
3/4/2015	1.64	1.81	1.67	1.69	1.81	1.69	1.62	1.57	1.56	1.60	1.63	1.59
3/5/2015	1.70	1.65	1.75	1.56	1.89	1.58	1.66	1.62	1.57	1.61	1.66	1.60

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
2/27/2015	1.690	1.637	1.623	1.612	1.750	1.894	1.990	2.165
3/2/2015	1.690	1.665	1.620	1.617	1.740	1.907	2.003	2.188
3/3/2015	1.690	1.636	1.643	1.594	1.775	1.922	2.035	2.210
3/4/2015	1.690	1.583	1.710	1.654	1.885	1.985	2.145	2.231
3/5/2015	1.580	1.581	1.678	1.579	1.880	1.990	2.132	2.311

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
2/27/2015	6.10	6.38	6.75	7.15	7.15	2.50	0.59
3/2/2015	6.26	6.48	6.90	7.30	7.30	2.50	0.59
3/3/2015	6.31	6.50	6.88	7.25	7.25	2.45	0.68
3/4/2015	6.10	6.41	6.78	7.15	7.15	2.45	0.64
3/5/2015	6.10	6.38	6.70	7.10	7.10	2.37	0.59

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
2/27/2015	4.1495	3.6980	3.8919	3.0970	1.3699	0.1508
3/2/2015	4.1559	3.7053	3.8742	3.0916	1.3693	0.1510
3/3/2015	4.1557	3.7190	3.8728	3.1051	1.3643	0.1514
3/4/2015	4.1723	3.7485	3.8930	3.1348	1.3590	0.1521
3/5/2015	4.1415	3.7525	3.8735	3.1284	1.3567	0.1510

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