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Polish Weekly Review

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Comment on the upcoming data and forecasts

A very busy week ahead of us. On Monday the NBP will release BoP and money supply data. As for the former, we expect the CA deficit to widen significantly, mainly on the back of a big trade deficit(forecast revised after latest GUS data). As for the latter, the deceleration in M3 growth is a result of high statistical base in cash in circulation, while mutual fund outflows likely boosted household deposits. Tuesday will bring the August CPI. We believe that low food and fuel prices and a drop in airline fares allowed the CPI to stay at -0.7%, despite base effects. Labor market data, to be released on Wednesday, should bring some stabilization: unchanged employment growth and a slight acceleration in wages. The week in Polish data ends on Thursday with the release of industrial output and retail sales figures. Both will be affected by the massive heat wave in the first half of August. The associated power outages and logistic delays probably depressed industrial output in a significant way. Thus, we expect only a slight acceleration on annual basis, despite calendar effects (+1 y/y vs. 0 in July) and low statistical base in car production. The impact of the heat wave on retail sales should be less pronounced but nevertheless negative, leading to stagnation in y/y growth. The PPI probably cratered due to commodity price declines.

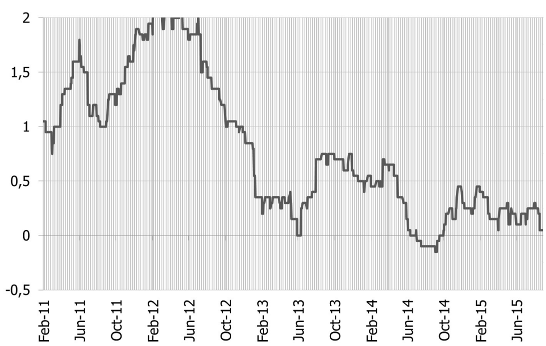
Polish data to watch: September 14th to September 18th

Publication	Date	Period	mBank	Consensus	Prior
M3 y/y (%)	14.09	Aug	8.1	8.0	8.6
Current account (mio EUR)	14.09	Jul	-1130	-527	-849
Exports (mio EUR)	14.09	Jul	13900	14317	14261
Imports (mio EUR)	14.09	Jul	14400	14212	14205
CPI y/y (%)	15.09	Aug	-0.7	-0.7	-0.7
Core inflation y/y (%)	16.09	Aug	0.2	0.4	0.4
Average wage y/y (%)	16.09	Aug	3.7	3.5	3.3
Employment y/y (%)	16.09	Aug	0.9	0.9	0.9
MPC Minutes	17.09	Sep			
Sold industrial output y/y (%)	17.09	Aug	5.6	6.2	3.8
PPI y/y (%)	17.09	Aug	-2.7	-2.3	-1.7
Retail sales y/y (%)	17.09	Aug	1.4	1.5	1.2

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	9/24/2015	1500	1.667	6/11/2015
5Y T-bond PS0720	9/24/2015	3000	2.355	7/23/2015
10Y T-bond DS0726	-	2000	3.076	9/10/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Unchanged (no data releases this week). Next week brings all the important publications: CPI, PPI, industrial output, retail sales. Thus, it is shaping up to be a volatile week for our surprise index.

* 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

- GDP growth stabilized around 3.5% per annum.
- H2 2015 is expected to bring more (positive) exogenous components to the Polish cycle. Lower costs of financing, generally lower budget deficit and the beginning of a new round of infrastructure spending are expected to give way to expenditures related to political business cycle ahead of general elections.
- Given the schedule of infrastructure spending and stable consumption growth, 2-3 years of economic expansion are our baseline scenario for Polish economy. Upswing phase can be flatter than we historically got used to but longer. Such an outcome almost guarantees that the likelihood of bottlenecks in the economy is small.
- Inflation recorded a slight turnaround and we await higher readings in coming months. However, output gap is too wide to generate inflation pressure and therefore inflation is going to stay low (very low). Prices are going to stay in deflation until winter.
- Rate cut cycle has been concluded and rates are going to stay at 1.5%. 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 turn constructive on 10y bonds. Although the EM crisis is still ongoing, the focus of investors turned to policy response. ECB acted first promising more accommodation if needed and lowering forecasts; other central banks are set to follow. Play for QE extension is going to support the zloty and break non-favorable correlations with Polish assets.
- Locally, we see more scope for rate cuts being priced in. Drought theme is overdone given the favorable crop worldwide and may lead only to temporary higher prices of vegetables and fruits (no risk for low inflation path whatsoever). Polish bonds recently cheapened versus Hungarian ones while political risk seems to be digested. Among slowing EMs, Polish balanced growth may be seen as a sweet spot reducing credit risk and enabling lower risk free rates to filter through Polish bonds.
- Pro-active ECB stance should be enough to shield the zloty from sharp depreciation in case of higher risk aversion. In such circumstances stable growth story is going to be enough to trigger positive differentiation flows. Local problems remain unsolved, though. The fate of CHF conversion bill is going to be the one of utmost importance in coming days as it returned to the lower chamber of the parliament. That is why we neutralize our outlook for the zloty betting on the middle of interval 4.10-4.30.

mBank forecasts

	2010	2011	2012	2013	2014	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	-0.1	-0.8
Current account (%GDP)	-4.5	-4.9	-3.5	-1.3	-1.2	-0.6
Unemployment rate (end of period %)	12.4	12.5	13.4	13.4	11.5	10.0
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	2015 Q2 F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.5	3.6	3.3	3.3	3.6	3.3	3.6	3.4
Individual consumption y/y (%)	3.0	3.0	3.2	3.0	3.1	3.0	3.0	3.2
Public Consumption y/y (%)	0.5	6.4	5.3	6.4	3.3	2.4	2.5	1.5
Investment y/y (%)	11.4	8.7	9.2	8.6	11.4	6.4	8.0	7.5
Inflation rate (% average)	0.6	0.2	-0.3	-0.7	-1.4	-0.9	-0.8	0.1
Unemployment rate (% eop)	13.9	12.0	11.5	11.5	11.7	10.3	10.0	10.0
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	1.65	1.72	1.72	1.72
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.79	1.61	1.99	1.70	1.70
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.31	3.31	3.00	2.90
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.07	4.19	4.20	4.15
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.80	3.76	3.56	3.67

F - forecast

Economics

2016 budget bill carries much risk but it's not a reason to be worried

On Monday Polish government approved the draft of 2016 budget bill. It assumes a sizable increase in revenues comparing to 2015 (by almost 6 bn PLN) and an increase in expenditure limit from 343.3 bn in 2015 to c. 351.5 bn (by 2.4%). Maximum deficit could grow from 46.08 bn to 54.52 bn.

Just as every year, assuming higher deficit does not straightforwardly means loosening fiscal policy, because expenditure caps include large margins for errors. Actual performance of budget spending is usually at least 10 bn lower than the statutory limit. In current, conservative version of budget, expenditure side should not be a reason for concern because it is to a large extent controlled by the MoF; the same applies to downside risks for some categories (debt service costs). On the other hand, fulfilling revenue targets seems much more dubious.

Firstly, macroeconomic assumptions are quite optimistic - GDP growth at 3.8% (5.1% in nominal terms) boosted mainly by private consumption (which moves to 3.7% from 3.0% y/y); average inflation at 1.7%. In our opinion, this forecast carries negative risk not only when it comes to growth rate but growth structure as well. Acceleration of private consumption from 3.0% y/y to 3.7% y/y with slowdown of real wage bill from 5.7% y/y (recorded in first months of current year) to 2.9% y/y is only possible when making unreasonable assumptions about household saving rate.

Secondly, downward inflationary risks could result in lower than expected nominal macroeconomic aggregates, which are the base for budget revenues' largest category - VAT. Combination of low inflation rate (deflation) and nominal GDP growth rate "at crisis levels" means that inflow of indirect tax revenues is consistently disappointing.

Thirdly, non-tax revenues also include certain bold assumptions. While sustaining this year's levels of dividends from state-controlled companies is at least controversial (taking into account total effect of collapse of resources prices for mining, energetic and petroleum companies), the assumption of National Bank of Poland profit (3.2 bn) has to be analyzed very carefully. In recent years budgets assumed no payments from central bank, which often resulted „positive surprises" and sizeable support for the budget. In 2011 and 2012 NBP's profit rescued the budget – there is no such margin for error in 2016 now.

To summarize, budget bill in current shape carries much risk on the revenue side and we have to take into account that it could be amended in 2016. There are two basic scenarios that would result in significant budget changes: (1) either economic situation will deteriorate substantially, which we cannot foresee right now, but it could determine 2016 budget policy as soon as in the first quarter of 2016; (2) or in the aftermath of September elections the newly formed government could adjust fiscal policy along the line of its election program. If the latter happens, we do not envisage a significant amendment. Finally, the reality of higher deficit in 2016 was acknowledged by MinFin Szczurek who admitted that the goal of 2.3% deficit in 2016 is not realistic.

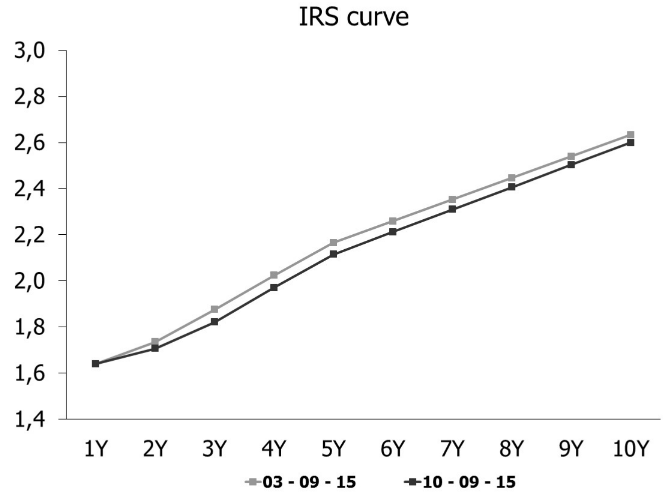
Last but not least, the issue of large net financing needs is not serious, in our view. The extra supply can easily be absorbed by local banks if the central bank decides to abandon Polonia rate stabilization and boost banks' demand for short-term government debt.

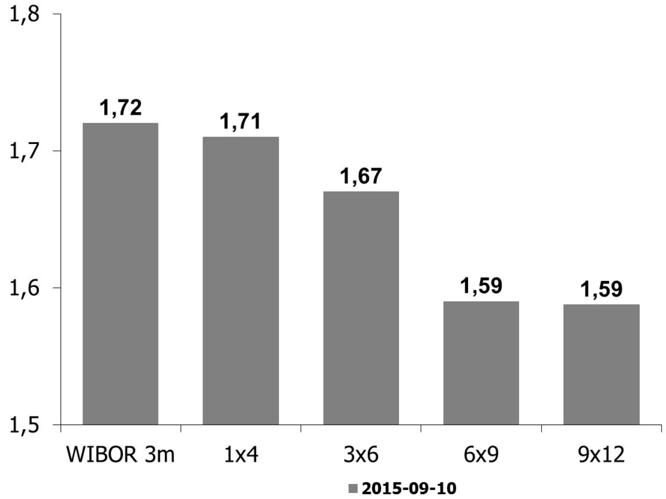
Fixed income

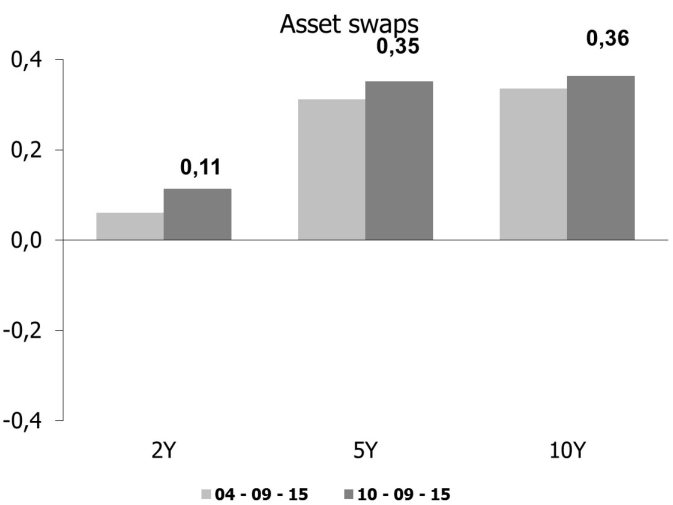
Waiting for the FOMC

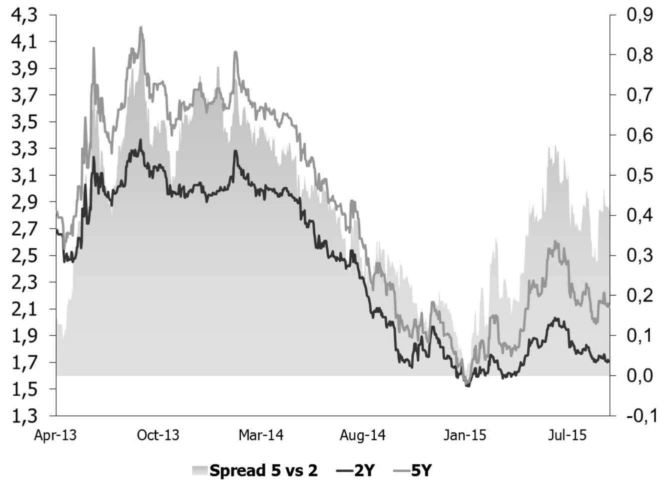
This week was really calm on Polish FI market – yields fluctuated in a 5-8bps range (PS0420 2,38-2,44%; DS0725 2,91-2,98%) – POLGBs followed Bunds. With a lack of domestic data publication, the main event was Thursday's long duration auction. Ministry of Finance sold new 10y fixed bond DS0726 with 3,066% yield and WZ0126 floaters; results were rather poor with demand at 4,2 bn (2-4bn was on the offer) and the MoF accepted 3,02 bn of bids. Investors weren't confused with such an outcome as the market is not happy to take additional risk ahead of FOMC meeting.

Everybody knows that FOMC decision is crucial for emerging markets, everybody knows that the lift-off is not obvious (traders are pricing only a 26% probability of such move), everybody knows that Yuan devaluation, dovish ECB stance, uneven economic data don't support such decision, but we do see such risk higher than 26% and thatâ€™s why we decided to square our long bond position.









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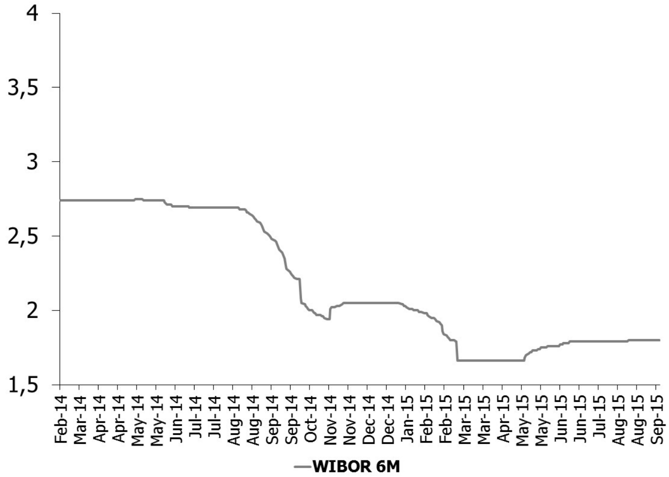
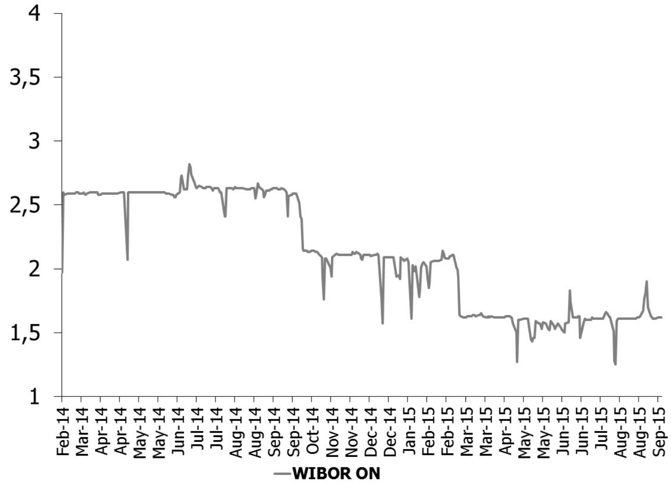
Money market

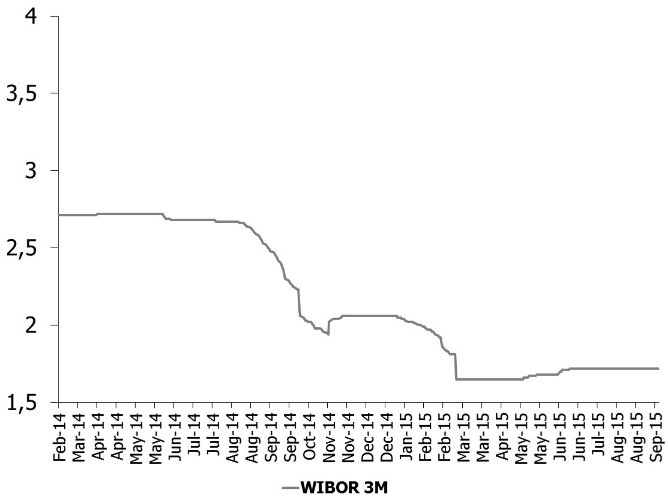
Calm week behind us

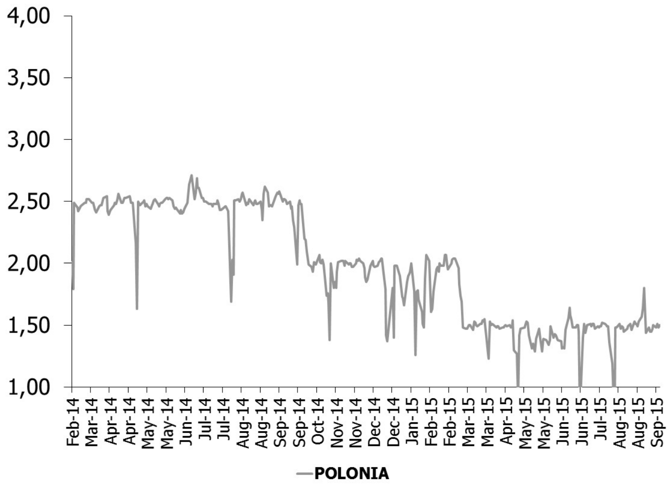
Market was steady this week. Polonia fluctuated around 1.50. Next week will be probably the same as well. OIS rates are stable. 1W OIS is now 1.45/1.50. Longest ones are a bit lower. We noticed some interest in paying shortest FRAs. 3x6 bid is now around 1.67-1.68 (so possibility of any rate cut this year is tiny).

Shortest bond yields fell this week. OK0116 is now 1.61/1.56. It will be the switching bond for auctions in October so we think it's a good idea to buy it.





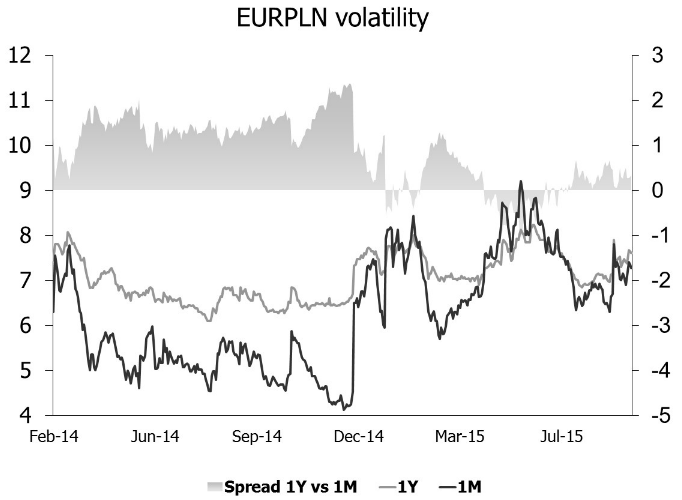




Forex

PLN – even stronger EUR/PLN is still boxed in a tight 4.1990-4.2400 range. We are still waiting for some fresh signal to push us out of the current range. The most obvious candidate is the next the week FOMC meeting. In case we get a hawkish message, the 4.24/4.26 resistance zone should be at least tested. If the message will be dovish, the move below 4.20 should be immediate. We are bit skewed to the downside in the EUR/PLN, because of the dovish ECB, CHF bill somehow fading and positive correlation with EUR/USD, all that makes us think that PLN should gather momentum at least against the EUR in the near future.

Options – volatility higher Although Zloty was quite strong last week, there has been consistent option buying in the market. So, because of high realized volatility, correlation between stronger PLN and lower volatility doesn't work anymore. 1 month EUR/PLN ATM is now 7.15% (0.65% higher), 3 months are 7.35% (0.35% higher), and finally 1 year are fixing 7.6% (0.3% higher). The skew is roughly 0.15% higher. The currency spread was bit softer USD/PLN.



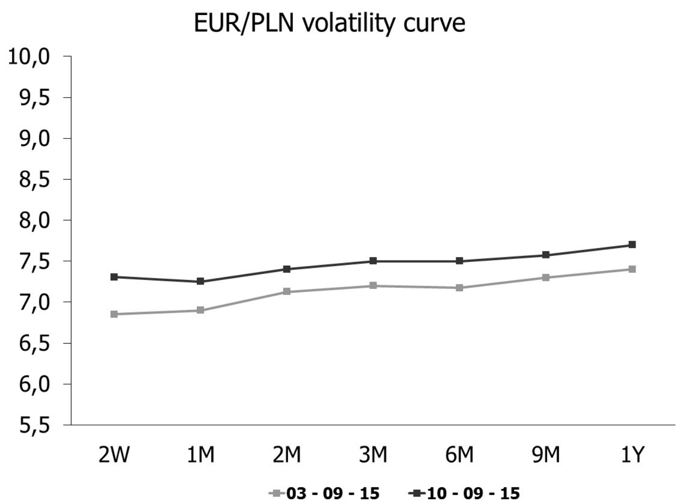
Short-term forecasts

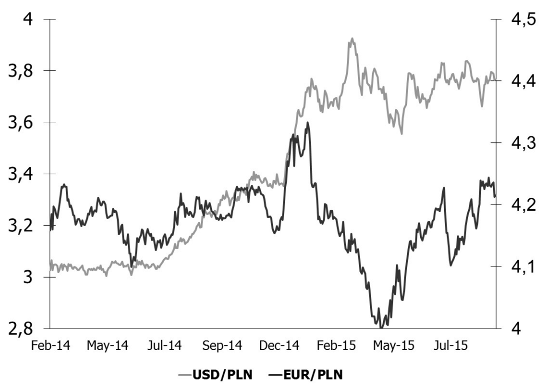
Main supports / resistances:
EUR/PLN: 4.16 / 4.26
USD/PLN: 3.60 / 3.85

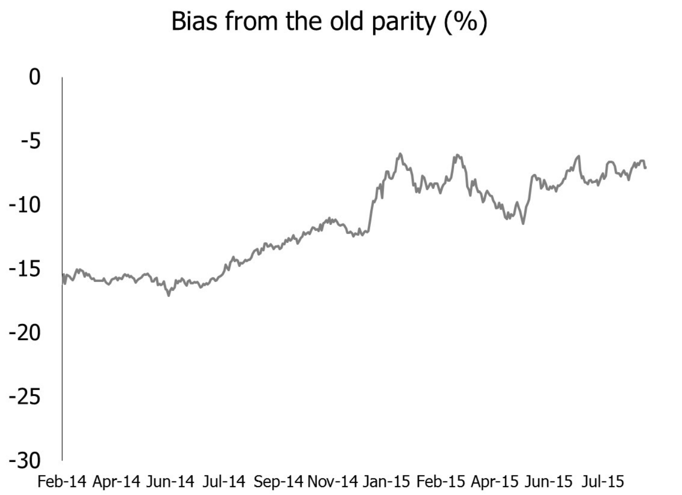
Position Spot – Our position unchanged. We are still short at 4.2280 and we are ready to add at 4.2500 with a stop above 4.2600 and hopes to revisit levels below 4.1700.

The Senat (upper house of the Parliament) has rejected the CHF bill, by sending it back to Sejm (lower house of Parliament) it made it quite difficult to pass the bill before elections. In other words, the huge systemic risk to PLN was at least postponed if not reversed. The dovish ECB is another strong factor, and reason we became overall PLN positive.

Options We are still long Vega and Vanna in EUR/PLN and USD/PLN. The position was nevertheless reduced last week. The Gamma still covers Theta bills, so we are not really worried. There are still FOMC and Polish elections in front of us, and we prefer to be long Gamma/Vega into these events.







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
9/3/2015	1.78	1.72	1.85	1.70	1.75	1.73	1.71	1.67	1.61	1.60	1.64	1.67
9/7/2015	1.68	1.72	1.77	1.70	1.78	1.73	1.71	1.67	1.60	1.59	1.62	1.65
9/8/2015	1.57	1.72	1.77	1.70	1.78	1.73	1.71	1.68	1.60	1.59	1.63	1.66
9/9/2015	1.48	1.72	1.56	1.70	1.60	1.73	1.71	1.68	1.60	1.59	1.63	1.66
9/10/2015	1.56	1.72	1.62	1.70	1.75	1.73	1.71	1.67	1.59	1.59	1.62	1.65

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
9/3/2015	1.730	1.695	1.735	1.817	2.165	2.504	2.633	2.976
9/7/2015	1.730	1.647	1.700	1.784	2.120	2.451	2.585	2.946
9/8/2015	1.730	1.676	1.720	1.786	2.140	2.473	2.620	2.991
9/9/2015	1.730	1.681	1.713	1.794	2.135	2.487	2.615	2.972
9/10/2015	1.730	1.649	1.706	1.819	2.115	2.466	2.600	2.963

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
9/3/2015	6.90	7.20	7.18	7.40	7.40	2.07	0.56
9/7/2015	7.40	7.40	7.45	7.68	7.68	2.07	0.56
9/8/2015	7.35	7.40	7.43	7.65	7.65	2.12	0.57
9/9/2015	7.28	7.38	7.43	7.60	7.60	2.08	0.57
9/10/2015	7.25	7.50	7.50	7.70	7.70	2.03	0.53

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
9/3/2015	4.2314	3.7645	3.8840	3.1289	1.3460	0.1566
9/7/2015	4.2335	3.7928	3.8983	3.1796	1.3473	0.1566
9/8/2015	4.2360	3.7878	3.8843	3.1581	1.3475	0.1566
9/9/2015	4.2129	3.7634	3.8666	3.1249	1.3451	0.1559
9/10/2015	4.2153	3.7648	3.8570	3.1152	1.3406	0.1559

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