December 18, 2015

Polish Weekly Review

Department of Economic Analysis
(research)

Ernest Pytlarczyk, PhD, CFA
chief economist
tel. +48 22 829 01 66
ernest.pytlarczyk@mbank.pl

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@mbank.pl

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@mbank.pl

Karol Klimas
analyst
tel. +48 22 829 02 56
karol.klimas@mbank.pl

Department of Financial Markets
(business contacts)

Wojciech Dunaj
head of interest rates trading
tel. +48 22 829 07 51
wojciech.dunaj@mbank.pl

Marcin Turkiewicz
head of fx trading
tel. +48 22 829 01 67
marcin.turkiewicz@mbank.pl

Department of Financial Markets Sales
(business contacts)

Inga Gaszkowska-Gebska
institutional sales
tel. +48 22 829 01 67
inga.gaszkowska-gebska@mbank.pl

Jacek Jurczyński
head of treasury sales
tel. +48 22 829 15 16
jacek.jurczynski@mbank.pl

mBank S.A.
18 Senatorska St.
00-950 Warszawa
P. O. BOX 728
tel. +48 22 829 00 00
fax. +48 22 829 00 33
http://www.mbank.pl

Table of contents

Comment on the upcoming data and forecasts

Next three weeks look quite calm in term of economic publications as turn of the year always is. This Wednesday CSO will publish its Statistical Bulletin, with unemployment data. According to preliminary data (presented by MFLSP) it climbed slightly up in December, just as market consensus had suggested. We will also see details of positive surprises in real sphere data. On 4th January *flash* CPI inflation for December will be published. We think that it will remain negative, maybe even through most of Q1. However, precise inflation forecast depends on CSO Bulletin details. Approval of gas and electricity price cuts from 2016 will hamper the return of inflation to positive value, not even mentioning going near inflation target.

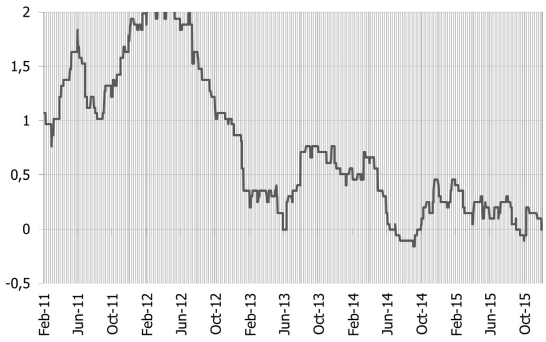
Polish data to watch: December 21st to January 8th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	23.12	Nov	9.7	9.7	9.6
CPI inlation *flash* y/y (%)	04.01	Dec	-0.2	-0.6	-0.6

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 OK0717	11/19/2015	1000	1.770	10/29/2015
5Y T-bond PS0720	11/19/2015	3000	2.317	10/29/2015
10Y T-bond DS0726	11/19/2015	2000	3.076	10/29/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Last week brought a lot of data but only few were able to move the index. Negative surprise in final CPI release outweighed positive one in industrial production, hence our index continues downward trend. CSO unemployment release will probably confirm preliminary MFLSP data, so the next true opportunity to move the index comes on 4th January with CPI *flash* for December.

* 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

- GDP growth perspectives brightened recently.
- 500+ program is set to support private consumption in 2015. At the same time, global headwinds do not seem to be detrimental for Polish exports (see constantly decent business activity in euro zone). Although public infrastructure outlays have shifted towards the latter part of 2016, private investment outlook brightened due to expected faster growth path and burst of consumer optimism.
- Given the current lags of infrastructure spending and constantly fueled consumption growth (child subsidy now, higher tax allowance from 2017), many years of economic expansion are our baseline scenario for the Polish economy. The upswing 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.
- Current GDP growth is sufficient to keep inflation and credit risk in check. Globally low to moderate growth amid low commodity prices are set to further underpin deflationary environment. Headline inflation is going to slowly rise only on the back of statistical base.
- We expect lower rates in 2016. Polish monetary policy is going to converge with the one run by the NBH. Therefore we expect the newly elected MPC members to be more responsive to low inflation and government financing costs.

Financial markets

- Valuations of POLGBS (5Y and longer) look attractive already and credit risk looks too overpriced now (Polish assets display very high short term correlation with EMs at the time of stress).
- Wider ASW already improved attractiveness of POLGBs v. IRS. POLGBs cheapened vs. DM and euro peripherals
- Given the European low yield environment, rate cuts expectations in Poland should not evaporate completely (although they may be more FX dependent than previously believed, new MPC looks also less willing to cut rates aggressively than before) and a scenario of lower rates for longer should apply to Poland as well (that is why we suggest long end bonds).
- Zloty is to remain in the range (4.20-4.40). It might strengthen when foreign capital returns to the stock market.

mBank forecasts

	2011	2012	2013	2014	2015F	2016 F
GDP y/y (%)	5.0	1.6	1.3	3.3	3.5	3.6
CPI Inflation y/y (average %)	4.3	3.7	0.9	-0.1	-0.8	0.6
Current account (%GDP)	-4.9	-3.5	-1.3	-1.2	-0.6	-1.0
Unemployment rate (end of period %)	12.5	13.4	13.4	11.5	10.0	8.9
Repo rate (end of period %)	4.50	4.25	2.50	2.00	1.50	1.25

	2015 Q1	2015 Q2	2015 Q3 F	2015 Q4 F	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.7	3.3	3.5	3.5	3.5	3.5	3.7	3.8
Individual consumption y/y (%)	3.1	3.1	3.1	3.2	3.3	3.8	3.6	3.6
Public Consumption y/y (%)	3.7	2.5	2.7	1.2	0.5	2.0	2.0	2.0
Investment y/y (%)	11.5	6.1	4.6	4.0	6.0	7.0	7.5	8.0
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.3	0.2	0.6	0.5	0.9
Unemployment rate (% eop)	11.5	10.2	9.7	10.0	10.6	9.4	8.9	9.0
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.25	1.25	1.25	1.25
Wibor 3M (% eop)	1.65	1.72	1.73	1.70	1.44	1.44	1.44	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.80	1.45	1.45	1.45	1.45
10Y Polish bond yields (% eop)	2.31	3.31	2.84	3.10	3.10	3.00	3.00	3.00
EUR/PLN (eop)	4.07	4.19	4.25	4.35	4.30	4.25	4.25	4.20
USD/PLN (eop)	3.80	3.76	3.80	4.03	4.13	4.17	4.25	4.08
F - forecast								

Economics

Year ends with solid economic data with prolonged deflation

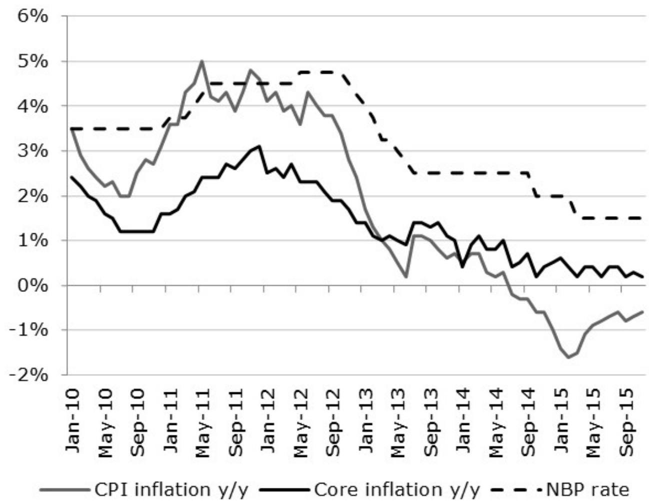
Solid real sphere and labour market data can be interpreted in two ways. First, as confirmation that the Polish economy remains in good shape and is regaining momentum (growth is thus set to at least stabilize at current levels in Q4/Q1). On the other hand, strong growth should partly dispel fiscal worries in Poland - after all, deficit and debt are more manageable with strong growth.

However for monetary policy in the following months will depend more on inflationary rather than real sphere data. Deflation, due to recently approved cuts in electricity and gas prices, could be more persistent. We still see a small correction in NBP rates as the baseline scenario - the MPC will likely test how deep it could go in the environment of diverging Fed / ECB policies. Furthermore, we believe that the NBP will take a more active role and employ non-standard instruments aimed at boosting credit (the negative reaction to bank asset tax will be a convenient excuse) and increase domestic demand for bonds.

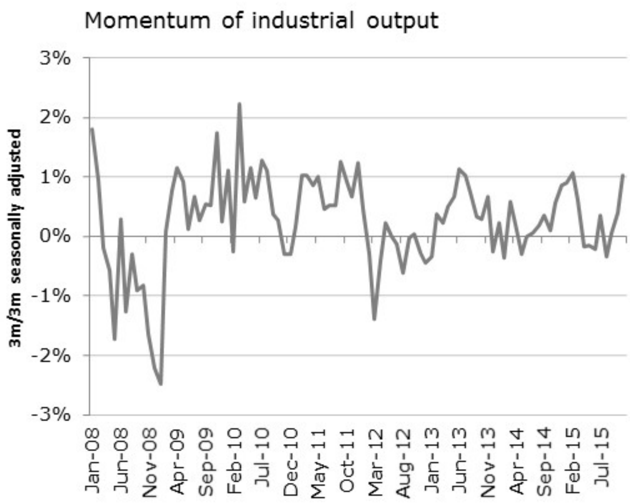
Below we present details about latest economic releases.

In November, Polish CPI **inflation** rose only slightly – from -0.7% to -0.6% yoy. The final release was not only lower than all forecasts but also lower than the flash estimate (-0.5%). The main reason for this surprise are low food prices - on a monthly basis they fell by 0.4%. Since we have consistent data (starting from 1997), this is just the second time food prices declined in November, but this year's reading is an all-time low. Food prices' slide seems substantial even taking account the large surprise in Czech Republic. Not only the scale of change is very surprising, we should mention also: 1) significant discrepancy with the data collected at the basic level of wholesale markets (zero vegetables' price momentum, which seems strange for us), 2) large drop in elastic, but historically not-volatile categories (bakery and dairy products) going vividly counter the developments in the wholesale markets.

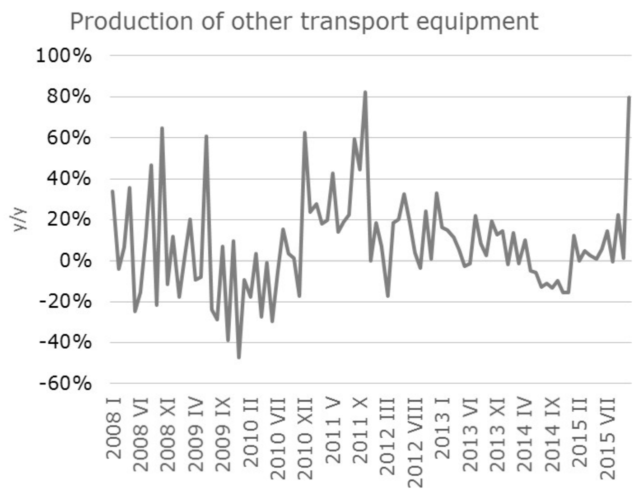
The remaining part of the basket did not surprise in a significant way: fuel prices grew marginally (this, coupled with base effects from last year, was the sole reason inflation grew at all!), core categories either stagnated on a monthly basis, or even declined a bit (communication, recreation and culture, clothing and footwear). According to our calculations, core CPI ticked down from 0.3% to 0.2% y/y (for the fifth time in recent months) and this shows the lack of inflationary pressures best. Given current trends on the commodity markets and the arrangement of statistical bases at the turn of the year, we believe that Poland will exit deflation in January. December is shaping up to come out at -0.2% y/y. Finally, inflation will stay low in 2016, only exceeding 1% at year end.



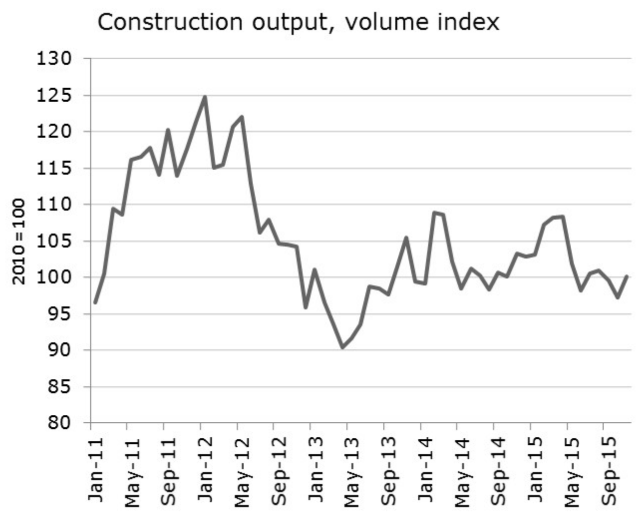
Industrial output rose by an astonishing 7.8% y/y, much higher than expectations (our forecast: 6.4% and market consensus: 5.7%). Main driver for this acceleration were calendar effects (+1 difference y/y vs -1 y/y in October). Seasonally adjusted data, which we thinks show the industry's true strength, showed very solid growth: 0.7% m/m. Momentum of industrial production reverted back near 1% (see chart below).



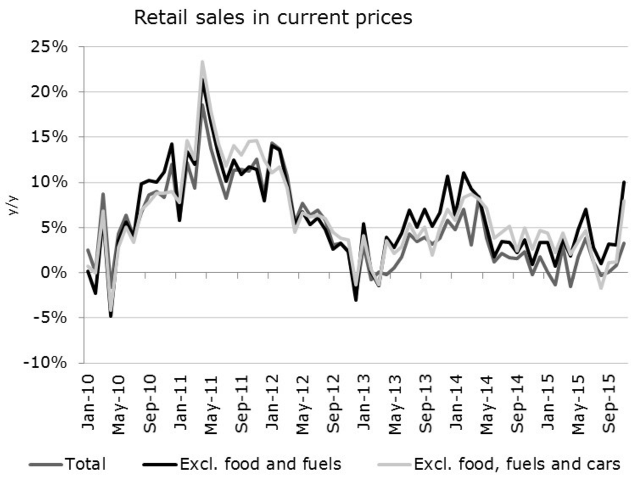
One particular category stands out in manufacturing growth – production of other transport equipment (containing e.g. trains and trams) rose by 79.7% y/y. This sector contributed 1.1 pp to annual industrial production growth and almost completely explains the difference between our forecast and today's release. However, this sector exhibits very high volatility and further conclusions about broader economic trends shouldn't be drawn from it. Still, it contributes to GDP growth.



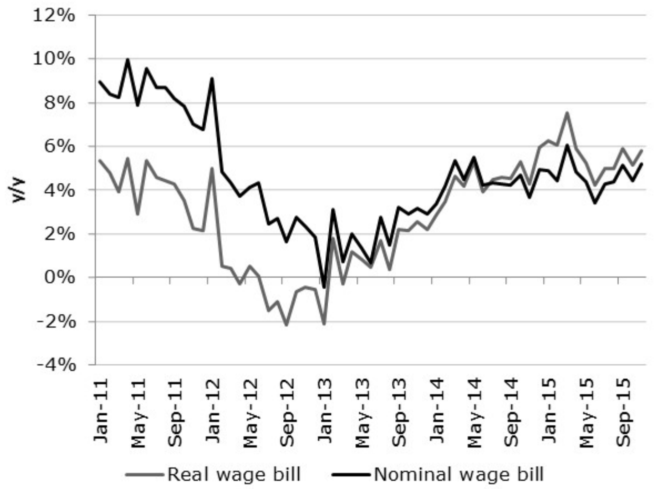
Construction output also surprised positively, rising by 1.2% y/y, much above market consensus which indicated contraction (market consensus and our forecast were at -3.6%). Excluding seasonal and calendar factors gives small growth of 2.9% m/m. From a further perspective, we do not see a breakthrough in construction (see chart below), and the upcoming months should bring only minor acceleration. There is a divergence in subsectors' perspectives: while residential investment shows strong growth and central road investments are also flourishing, business construction struggles with oversupply of commercial and office space and local government and railway investment have to deal with a hiatus in EU fund flows. Year 2016 will bring only modest growth of construction sector.



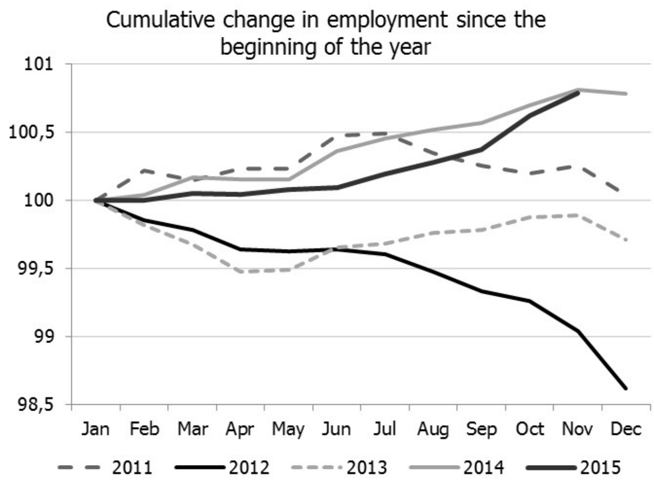
Retail sales grew by 3.3% y/y, beating consensus (2.2%) and coming close to our forecast of 3.5%). The result is largely due to base effects - car sales which grew by 20.4% y/y are the main culprit here - and calendar effects. The main surprise is food sales which dropped by 3.1% (price effect is only a partial explanation) and shaved off 1.4 pp. from the headline. All durables and semi-durables accelerated in November (clothing, due to earlier start to seasonal sales, decelerated slightly in November) and our favorite core categories (see the graph below) surged to 2-year highs. This supports our forecast of significant acceleration in consumption in 2016.



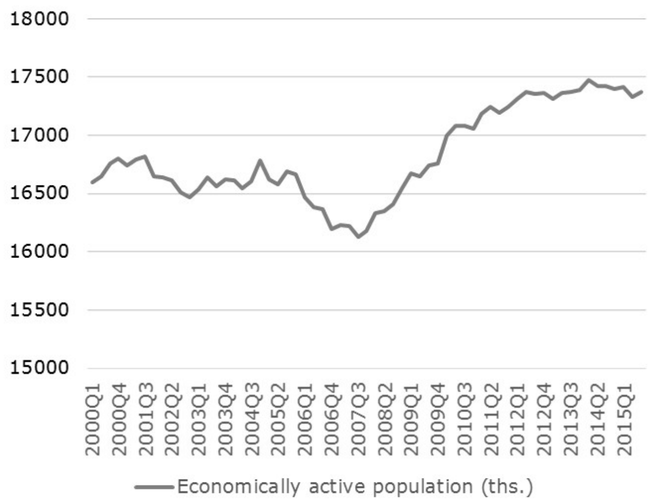
Average wage in Poland rose by 4.0% as compared to 3.3% in the previous month. This result is consistent with market consensus. The main drivers for this rise were base effects from the previous year (manufacturing, construction administration and its support) and working day difference (+1 y/y vs -1 y/y in October).



This confirms our long-term view that the trend in nominal wages stabilized between 3.5% and 4.0% y/y. Structural and demographic factors are, however, still strengthening employee bargaining power and in 2016 this pattern could be even intensified. Expected raises in public sector in 2016 could move "wage benchmark" in small cities and force private employers to also push wages higher. As a result, average wage growth in 2016 could exceed 5% and occur in even more sectors than in 2015. Implications for consumption are obvious, the more so since this process would offset growing inflation (which would diminish real household income). Private consumption will also be supported by new government policies (500+ programme).



Employment grew by 9.1 thousand jobs, which translated itself into a slight acceleration in annual growth rate, from 1.1 to 1.2% – for the second time in a row employment surprised to the upside and m/m growth was the fastest since 2007. As usual, we cannot comment on the sources of the surprise at this point. We believe that the main driver of employment might have shifted towards services (administration and support services, for instance). Nevertheless, the growing labor demand is meeting an increasingly binding demographic constraint, which is putting a cap on overall employment growth. Thus, we believe that employment growth should stabilize in an environment of declining labor force.



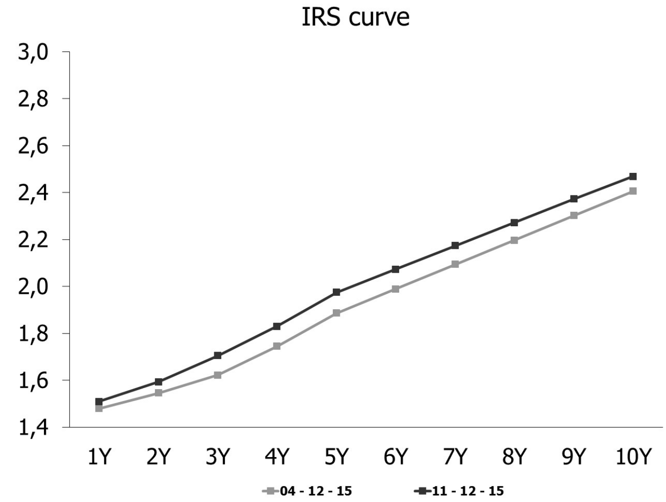
Fixed income

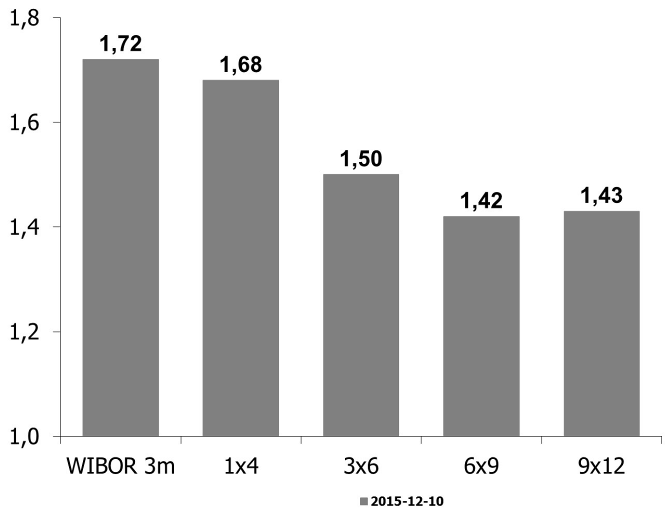
Rollercoaster

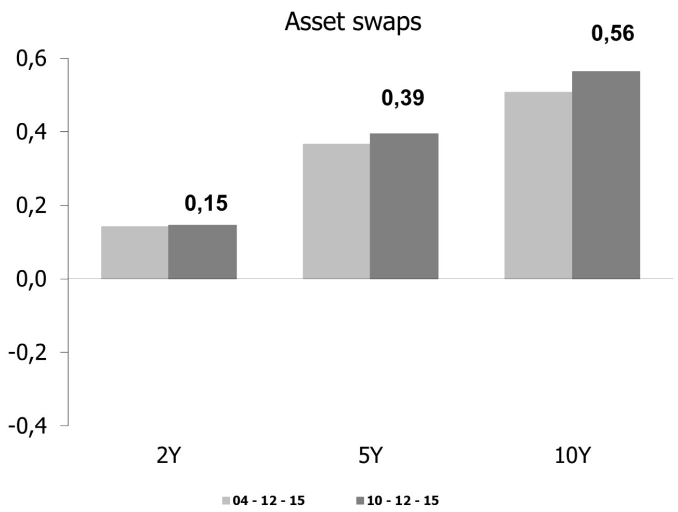
This week started with dynamic sell-off with several stop-losses were triggered (PS0420 reached 2.65%; DS0725 3.32%). Weakness of EMEA markets, implementation of asset tax, after switching auction bonds gravity and rebalancing before FOMC decision stayed behind market turmoil.

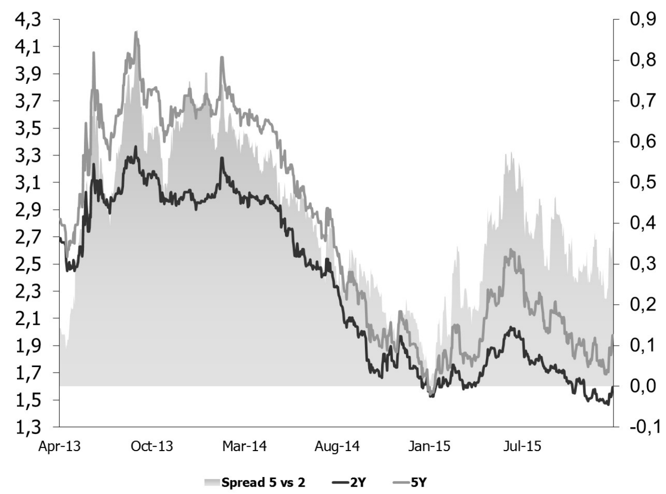
Just as expected, Federal Reserve delivered first rate rise in 10 years and caused relief rally all over the world - yields of POLGBS moved back almost to pre-auction levels (PS0420 2.28%; DS0725 2.90%). Governor Yellen mentioned about "gradual" normalization dozens of times, however please remember that market prices only half of FOMC Dots Projection.

We have to emphasise that liquidity this week was horrible and it's obviously not a good harbinger of market depth next year. We think that there is still small room for window-dressing trades which will push yields lower.









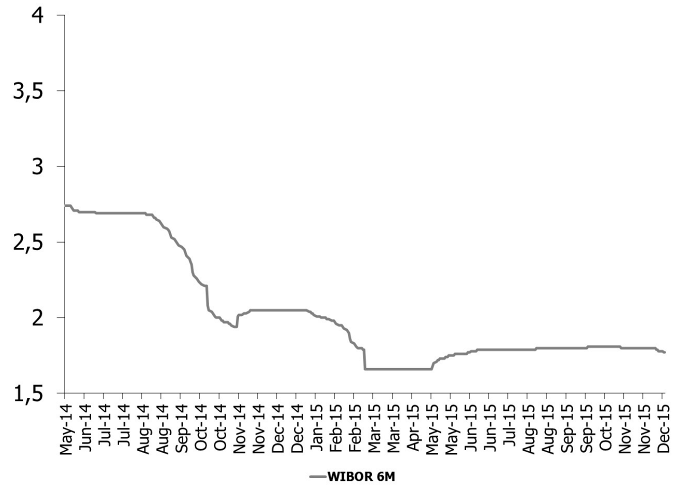
Money market

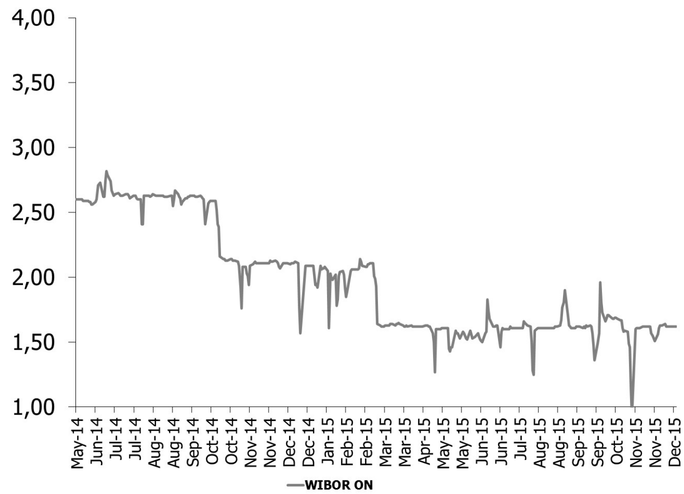
Stable week behind us

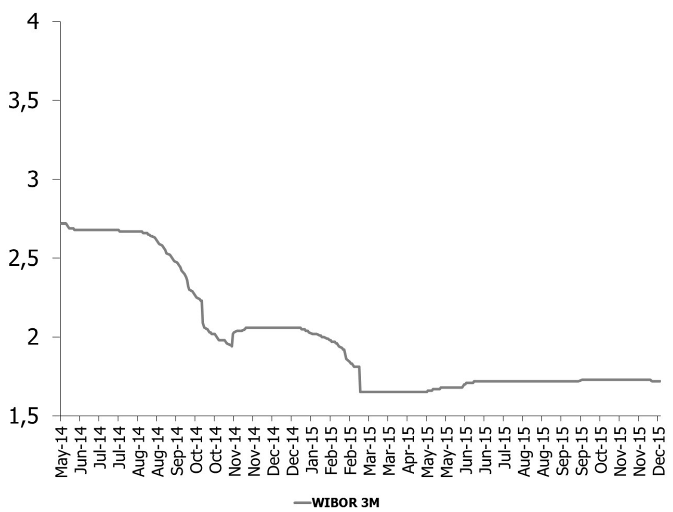
Stable cash market – Polonia has been fluctuating above 1.50 for the whole week. Next week is a bit shorter and as today's auction was underbid it should be a bit cheaper.

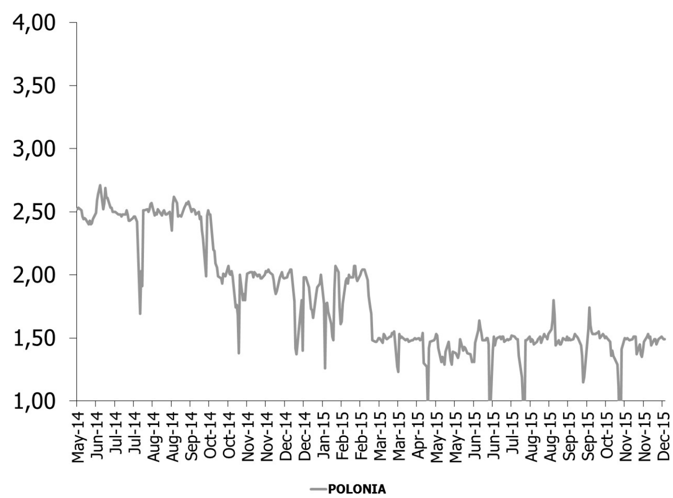
Week started bearish on the longer end. That movement pushed also front higher. FRA strip was flat at around 1.59. Now 6x9 is the lowest point on the curve (1.50) so we are discounting one rate cut. It's reasonable in our opinion.

While derivatives are lower again, shortest bonds are still cheap due to worries about bank tax. It looks like a good opportunity to buy them, thus we recommend it. Hedge it by OIS's and take 40 bps profit in 2016.



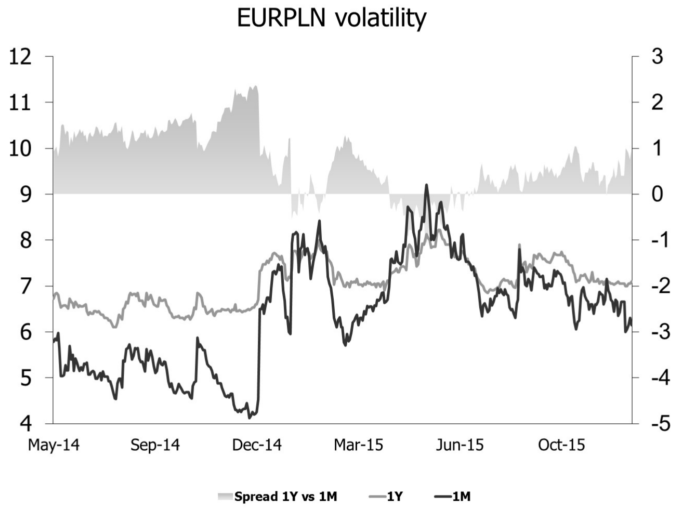






Forex

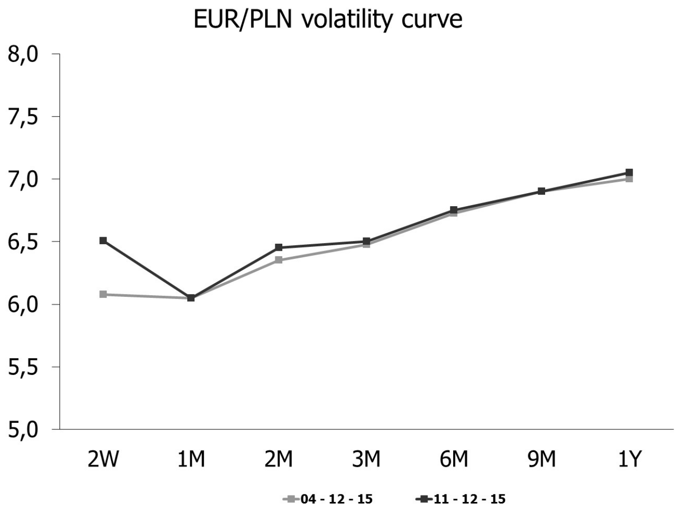
EUR/PLN – lower It was a good week for PLN, EUR/PLN dropped from 4.36 to 4.2785. With USD/PLN being more or less unchanged at 3.96, it means PLN is really stronger this Friday also in basket terms. Bigger picture is roughly unchanged, EUR/PLN is back in the middle of its wider 4.18/4.38 range. Correlation between EUR/USD and EUR/PLN is getting stronger. We are expecting a choppy, random moves due to poorer and poorer liquidity. The Polish political crisis, is not really recognized by markets, and is not adversely affecting PLN at the moment.



Options – another uneventful week 1 month EUR/PLN ATM mid is unchanged at 6.2% this Friday, 3 months 1 also unchanged at 6.5%. 1 year (surprise, surprise), fixes again at 7.1%. Skew is touch softer, as well as currency spread (USD/PLN vol. - EUR/PLN vol.). But there is one thing that, has changed, the spreads! These are generally higher by 0.3%, as more and more people pull back from active trading.

Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.18 / 4.38
USD/PLN: 3.85 / 4.05

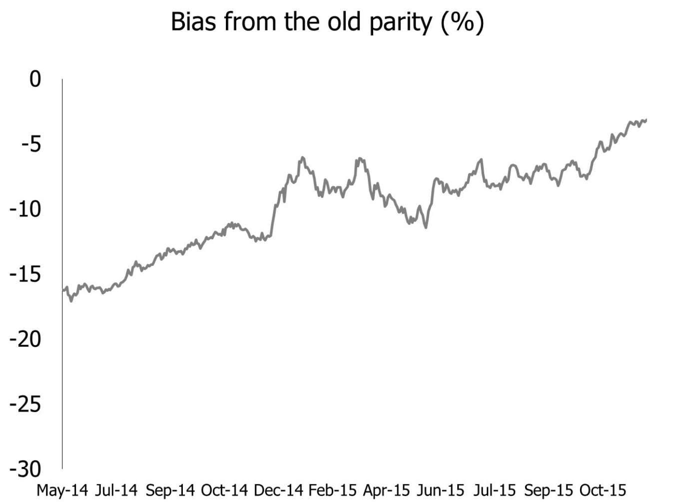


Position **Spot** – No position at the moment

We call it a year. The memories of the last year spike to 4.40 (Xmass Eve), is still alive. We prefer to be sidelined. The market may move in exaggerated fashion, on even modest flow.

Options – we are long 1 year Vega against 3 months (Vega neutral)

We think, that Party that have won the elections, would act more prudent while they will be having full responsibility for the country. Hence, would temper some of it is promises, and Poland generally healthy fundamentals will prevail. The loosening of fiscal conditions may influence us negatively in the future and that is the reason to be long 1 year ATM.



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
12/10/2015	1.76	1.72	1.72	1.67	1.55	1.69	1.68	1.50	1.42	1.43	1.48	1.45
12/14/2015	1.72	1.72	1.50	1.67	1.55	1.69	1.67	1.59	1.54	1.56	1.62	1.59
12/15/2015	1.62	1.72	1.68	1.67	1.69	1.69	1.68	1.57	1.51	1.53	1.59	1.55
12/16/2015	1.61	1.72	1.55	1.67	1.61	1.69	1.69	1.59	1.54	1.56	1.60	1.57
12/17/2015	1.70	1.72	1.67	1.67	1.72	1.69	1.69	1.58	1.51	1.52	1.55	1.55

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
12/10/2015	1.690	1.655	1.595	1.740	1.975	2.369	2.470	3.033
12/14/2015	1.690	1.826	1.690	1.931	2.130	2.643	2.588	3.280
12/15/2015	1.690	1.720	1.665	1.918	2.100	2.482	2.545	3.080
12/16/2015	1.690	1.716	1.693	1.856	2.145	2.543	2.595	3.132
12/17/2015	1.690	1.783	1.640	1.820	2.037	2.389	2.470	2.955

EUR/PLN 0-delta stradle						25-delta RR			25-delta FLY
Date	1M	3M	6M	1Y		1M	1Y		1Y
12/10/2015	6.05	6.50	6.75	7.05		7.05	1.59		0.41
12/14/2015	6.45	6.50	6.83	7.10		7.10	1.59		0.41
12/15/2015	6.30	6.58	6.83	7.05		7.05	1.69		0.47
12/16/2015	6.05	6.48	6.78	7.05		7.05	1.64		0.44
12/17/2015	6.00	6.58	6.83	7.03		7.03	1.69		0.47

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
12/10/2015	4.3440	3.9601	4.0083	3.2523	1.3720	0.1607
12/14/2015	4.3500	3.9695	4.0287	3.2784	1.3760	0.1610
12/15/2015	4.3580	3.9523	4.0222	3.2678	1.3742	0.1613
12/16/2015	4.3304	3.9644	4.0028	3.2508	1.3722	0.1602
12/17/2015	4.3048	3.9646	3.9817	3.2388	1.3638	0.1592

Disclaimer

Distribution and use of this publication The review note is based on the information available to the public. This review creates exclusively a marketing information as defined in Paragraph 9 Section 1 of the Decree of Minister of Finance dated November 20, 2009 on procedures and conditions to be followed by investment firms and banks mentioned in Article 70 Section 2 of Law on Trading in Financial Instruments dated July 29, 2005 as well as by custody banks. This review note is provided to you for information purposes only and is not intended as advice on any particular matter or as recommendation, offer or solicitation for purchase of sale of any financial instrument and should not be taken as such. mBank SA, its directors, officers, executives, managers, servants or agents expressly disclaim all liability to any person in respect of any-thing, and in respect of the consequences of anything, done or omitted to be done, wholly or partly, in reliance upon the whole or any part of the contents of this review note. The opinions and estimates contained herein reflect the current judgment of the author(s) on the date of this document and are subject to change without notice. The opinions pointed in review do not necessarily correspond to the opinions of mBank SA. The past performance of financial instruments is not indicative of future results. No assurance can be given that any financial instrument or issuer described herein would yield favourable investment results. mBank and/or its principals or employees may have a long or short position or may transact in the financial instrument(s) and/or securities referred to herein or may trade in such financial instruments with other customers on a principal basis. No client or other reader should act or refrain from acting on the basis on any matter contained in it without taking specific independent professional advice on the particular facts and circumstances in issue. Copyright protection exists in this publication and it may not be, even partially, reproduced of distributed without the prior written agreement with mBank SA.