March 18, 2016

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

A light week ahead of us. On Monday, the CSO will publish its business sentiment data. On Wednesday the Statistical Bulletin along with unemployment data will be released. We expect the latter to confirm the preliminary reading of 10.3%.

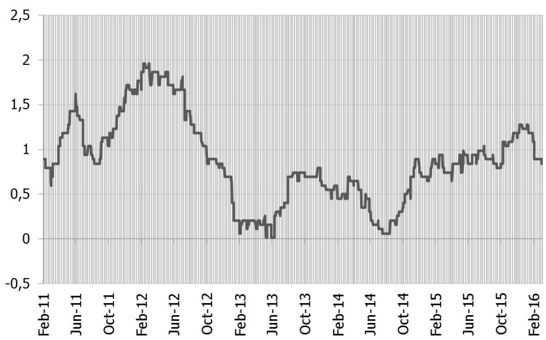
Polish data to watch: March 21th to March 25th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	23.03	Feb	10.30	10.30	10.30

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
(32/37/52) Week T-bills	-	1500	1.350	3/14/2016
2Y T-bond OK1018	4/7/2016	2700	1.553	3/3/2016
5Y T-bond PS0720	4/7/2016	4800	2.219	2/18/2016
10Y T-bond DS0726	4/7/2016	5500	3.014	3/3/2016
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Lower than expected CPI reading and positive surprise in industrial output data cancelled each other out, so no change on a weekly basis. Next week will bring stabilization as no significant data releases are scheduled.

* 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+ programme is set to support private consumption in 2016. At the same time, global headwinds do not seem to be detrimental for Polish exports (exports benefit from better euro zone momentum and weak zloty). Public infrastructure outlays have shifted towards the latter part of 2016 and private investment seems to be locally, negatively affected by political uncertainty. However, positive impulses from consumption and exports are set to encourage private capital formation amid stretched capacity utilization.
- Given the current lags of infrastructure spending and constantly fueled consumption growth (child subsidy now, higher tax-free 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.
- Rate cuts in 2016 are still a possibility. 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

- We stay positive on 10Y POLGBs (meanwhile 10Y bonds moved up by few bps in yield).
- Risk premium looks too high. Polish yield curve is extremely steep.
- Foreign investors' perception of Polish bonds improved recently (one cannot say the same on equities where sectoral story is still determined by politics).
- Polish zloty lately trades decently, supported by strong economic fundamentals and ECB stimulus and MPC's communication.

mBank forecasts

	2011	2012	2013	2014	2015	2016 F
GDP y/y (%)	5.0	1.6	1.3	3.3	3.6	3.8
CPI Inflation y/y (average %)	4.3	3.7	0.9	-0.1	-0.9	0.2
Current account (%GDP)	-5.2	-3.7	-1.3	-2.0	-0.1	-0.7
Unemployment rate (end of period %)	12.5	13.4	13.4	11.4	9.8	8.7
Repo rate (end of period %)	4.50	4.25	2.50	2.00	1.50	1.25

	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.7	3.3	3.5	3.9	3.6	3.8	3.8	3.9
Individual consumption y/y (%)	3.1	3.1	3.1	3.1	3.4	3.8	4.0	4.0
Public Consumption y/y (%)	3.7	2.5	2.7	4.8	0.5	2.0	2.0	2.0
Investment y/y (%)	11.5	6.1	4.6	4.9	5.5	6.0	6.0	6.6
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	-0.6	-0.3	0.2	1.3
Unemployment rate (% eop)	11.5	10.2	9.7	9.8	10.0	9.0	8.6	8.7
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.50	1.25	1.25
Wibor 3M (% eop)	1.65	1.72	1.73	1.72	1.68	1.68	1.44	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.62	1.35	1.35	1.35	1.55
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	2.90	2.80	3.00	3.20
EUR/PLN (eop)	4.07	4.19	4.25	4.26	4.35	4.25	4.25	4.20
USD/PLN (eop)	3.80	3.76	3.80	3.92	3.95	3.86	3.86	3.82

F - forecast

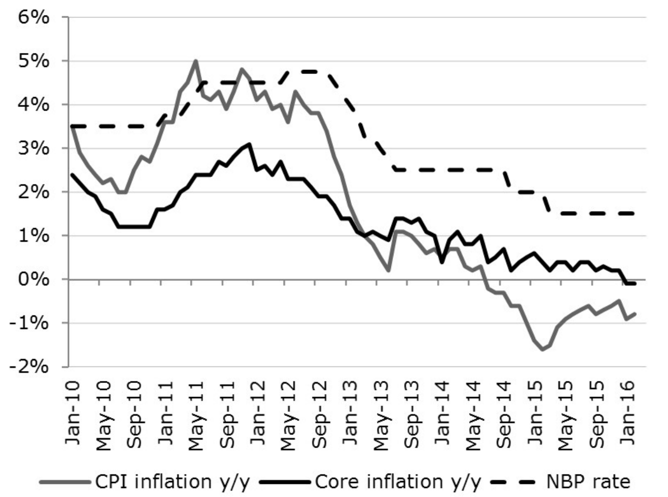
Economics

Trends are intact, and the current status quo in Polish monetary policy is more fragile than it appears.

The latest set of macro data from Poland turned out to be broadly consistent with recent trends: labor market remains a bright spot in the Polish economy (and keeps surprising to the upside), real sphere data suggest a slight slowdown in GDP in the first quarter of the year, the persistence of deflation is an integral part of the economic landscape. At the same time, the flurry of comments from new MPC members suggests that the current consensus of rate stabilization might not be as solid at it appears at first glance. First, at least four new members of the MPC are warming up to the idea of limited rate cuts. Second, the NBP staff projections have been slashed with an axe and the new Inflation Report could easily justify some monetary easing. Therefore, we still believe that the MPC can ease monetary policy this year in order to bring its stance closer to the European one, provided that risk premia drop further and that PLN continues to strengthen amid dropping volatility.

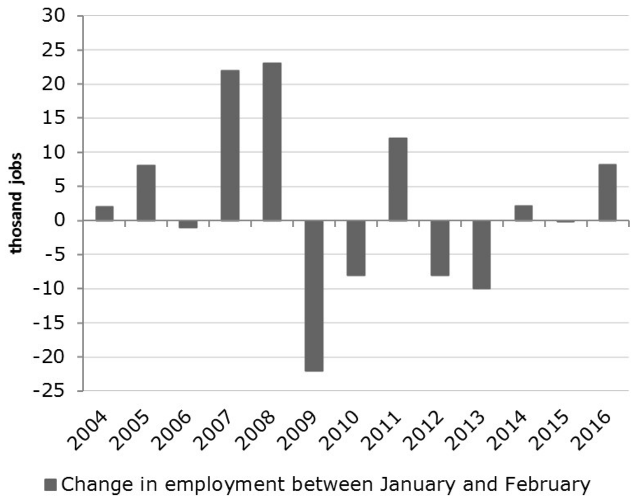
As usual, below you will find our detailed comments on this week's publications.

After the revision of **inflation** basket weights, January brought deflation of 0.9% magnitude and February only a slightly milder one, at 0.8%. The revision went along the expected direction but its scale was a notch higher. What is interesting, food prices seem to be slowly gathering momentum (as it happened throughout the region). After almost 10% drop in fuel prices in January and February, we see at least stabilization in March. Other categories show no inflationary pressures and core inflation has even dropped below zero for the first time in a decade. It is a mystery why Polish deflation continues to be attributed to purely external factors.

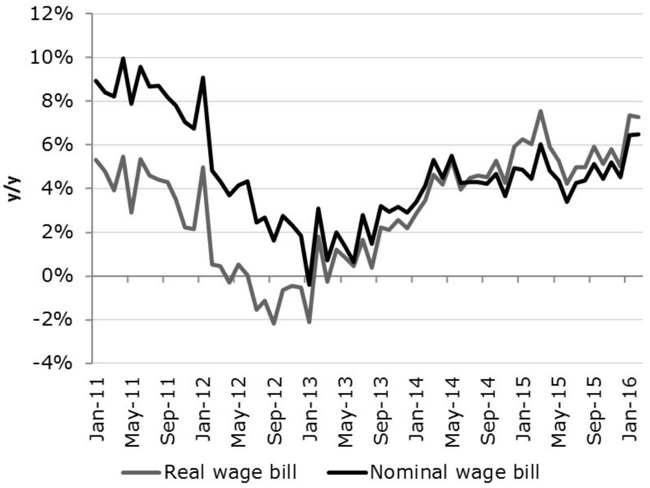


March reading is going to be similar. The revision in weighting (down: food and non-alcoholic beverages, fuels, hotels and restaurants; up: clothing and footwear, healthcare, recreation and culture, other goods and services) shifts our inflation path for 2016 uniformly lower. However, deflation still ends in September, and consumer price growth for the whole year will remain close to zero and December's annual reading touches 1.5%. Obviously, the slope of inflation path is going to be regulated by fuel prices; we see no meaningful upside risks at the moment, though.

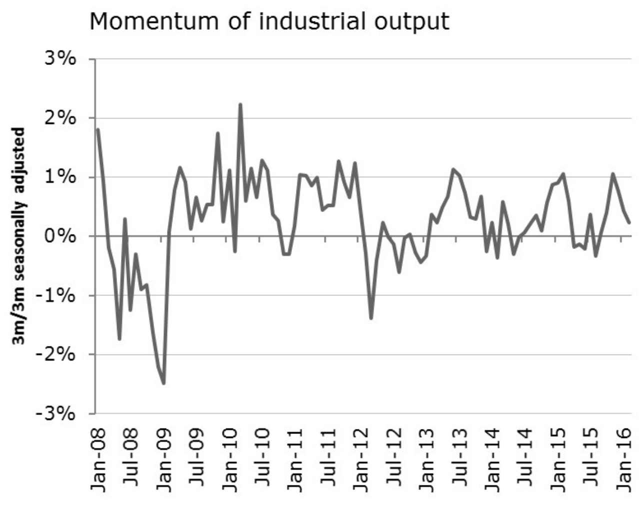
In February **wage** growth ticked down from 4.0 to 3.9% y/y, in line with our forecast and market consensus. Because of that we take for granted our own assumptions regarding the sectoral breakdown of wage growth. Delays in disbursements of coal mining bonuses were probably offset by acceleration in manufacturing (working day effect) and construction (very favorable weather conditions which boosted working time). Our view on wage growth in Poland is unchanged. In the coming months the on-going tightening of the labor market (demographic trends and the negative impact of child subsidy programme on labor supply in lowest deciles of income distribution) will result in wage growth in excess of 5% y/y.



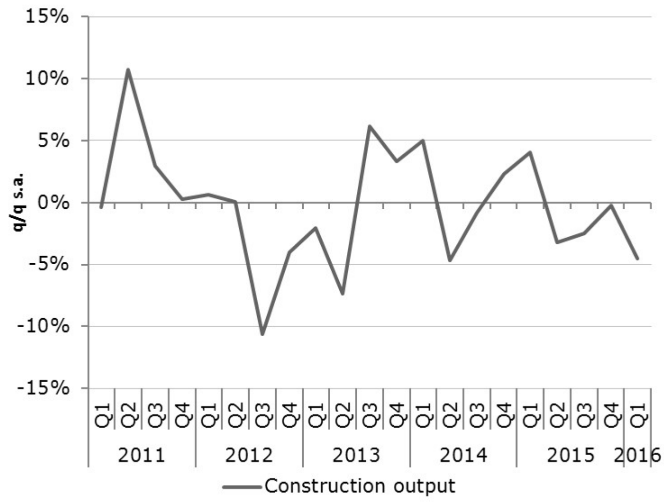
Employment surprised positively for the fourth time in a row, growing by 2.5% y/y (our forecast and market consensus â€“ 2.4% y/y). On a monthly basis this translates in a 8k gain in the number of the employed – the best February since 2011. This comparison, by the way, reveals the true strength of Polish labor market, not the annual figures distorted by sampling effects (we've written extensively about that in the previous month). As usual, we are unable to comment on the sources of the surprise. In our view, the most likely candidates are manufacturing and administration services. Nominal wage bill grew by 6.5% for the second time in a row. In real terms, annual growth rate barely declined (from 7.4 to 7.3%). Fast wage bill growth in conjunction with the upcoming child subsidy programme will result in a massive increase in real household disposable income, which will boost consumption this year.



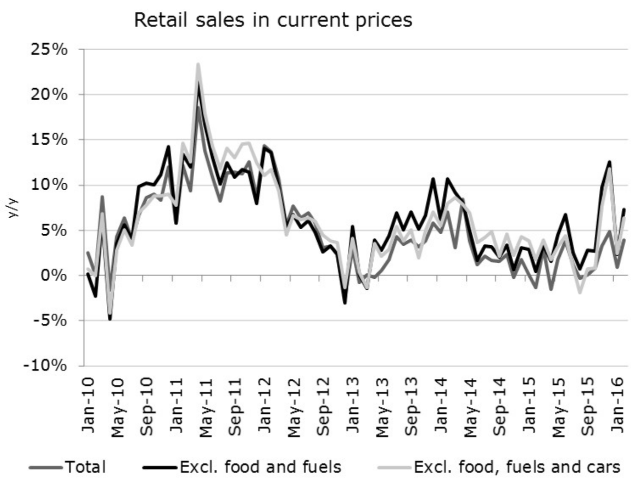
Industrial output grew by 6.7% on annual basis having grown by 1.4% in the previous month. This was slightly better than consensus forecasts. The acceleration vis-Ă -vis January data is almost completely explained by the difference in working days (+1 vs. -1 y/y). After seasonal adjustments, industrial output grew by 3.0% y/y and 0.2% m/m. Momentum is therefore little changed. Among the 29 industries that recorded y/y growth, export-oriented sections dominated the landscape (among them furniture, cars, textiles). The single biggest negative contribution came from energy output (an unfortunate side effect of a mild winter). We expect that export-oriented industries will fare well in the coming months, as currency depreciation is set to boost exports.



Construction output dropped by 10.5% on annual basis (seasonally adjusted -0.8% m/m), much below market consensus and our forecast (both around -6%). The slowdown happened despite favorable calendar effects and very mild weather (the warmest February in history). One slice the data in several ways and come to the same conclusion – construction is in a downturn. Consider, for instance, that output declined for the fourth quarter in a row (see the graph below). We have described the factors behind the weakness in construction in great detail before (austerity at local government level, hiatus in railway investment, slowdown in office and retail investment). We will simply add that recent information suggests that the hole in railway investment might be deeper than originally thought. All in all, we believe that construction output will barely inch above zero this year.



Retail sales grew by 3.9% in nominal terms and by 6.3% in constant prices. Growth slightly exceeded market expectations but was lower than our own forecast. Nevertheless, the deviations from our forecast were non unidirectional and we don't feel like we have overdosed optimism. Bright spots are primarily concentrated in durable goods sales (cars, household appliances) and food sales. Negative surprises are mainly fuel sales (a price effect mostly) and newspaper and book sales. The latter are not critical for the overall trend – and the trend is definitely positive. Even though one-off changes in classification distorted our favorite "core categories" but there is a positive trend among the noise. We remain optimistic regarding retail sales due to labor market strength and the upcoming surge in social spending (the child subsidy programme – 500 plus), and expect retail sales to accelerate to 10% y/y this year.

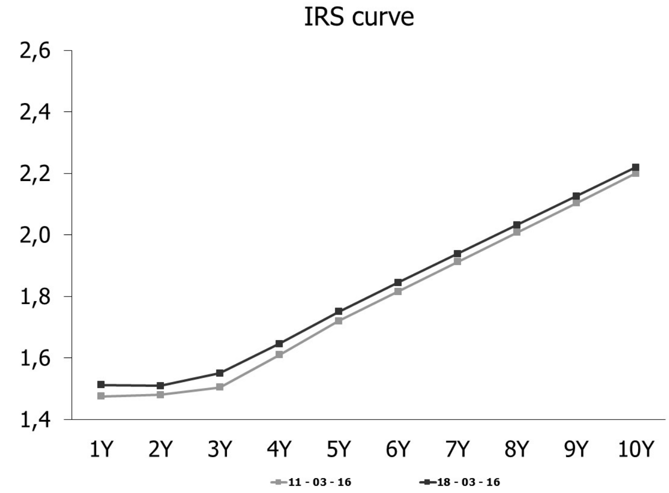


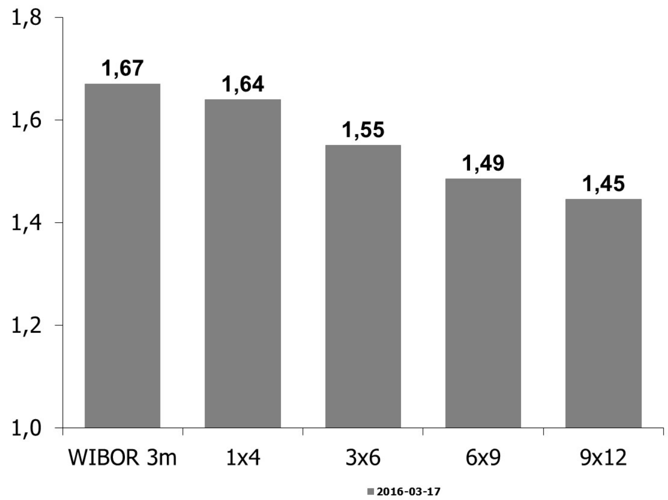
Fixed income

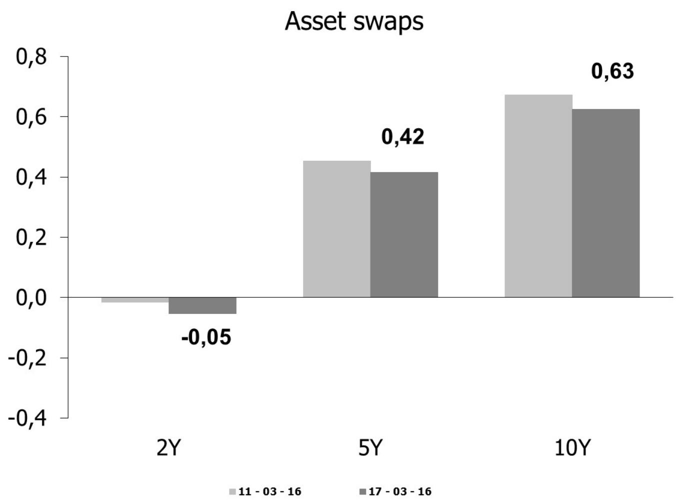
Market is extremely strong

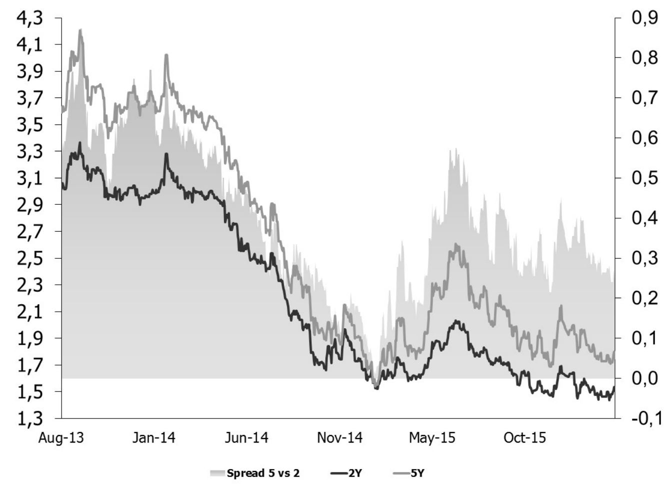
Market is still extremely strong. Prices decreased a bit before the Fed announcement but after dovish statement they rocketed by 8 bps. Now they are even higher (by 3 bps). ASW still narrowing. 10Y ASW is under 60 bps now and we still see some room to narrow (around 7-9 bps). Swaps are pretty stuck fluctuating in small range (6 bps. Just 2Y – 5Y spread is narrowing (22 bps now) as front end of the curve moved higher due to lower possibility of rate cuts.

We recommend to be long on the shortest swaps (under 5Y) and long on the longest bonds as they still got decent carry and demand remains huge. However, we would like to remind about tricky political situation in Poland which in our opinion might affect debt market soon.









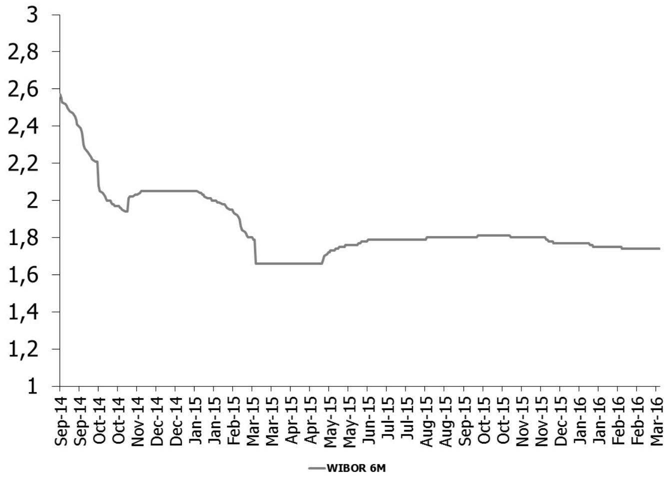
Money market

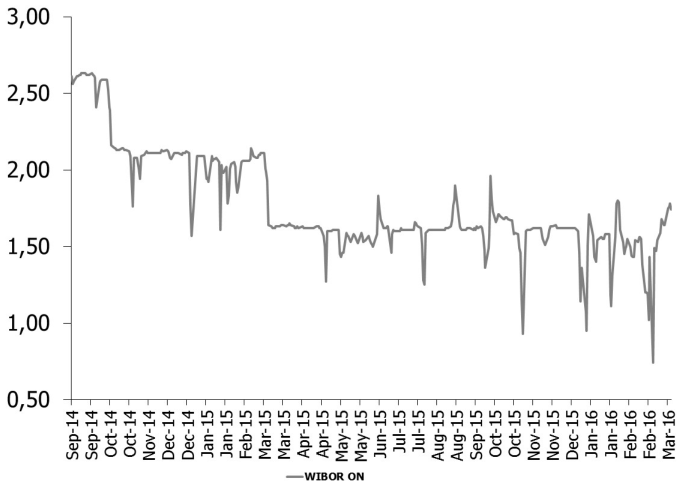
Some bumps in cheap cash scenario

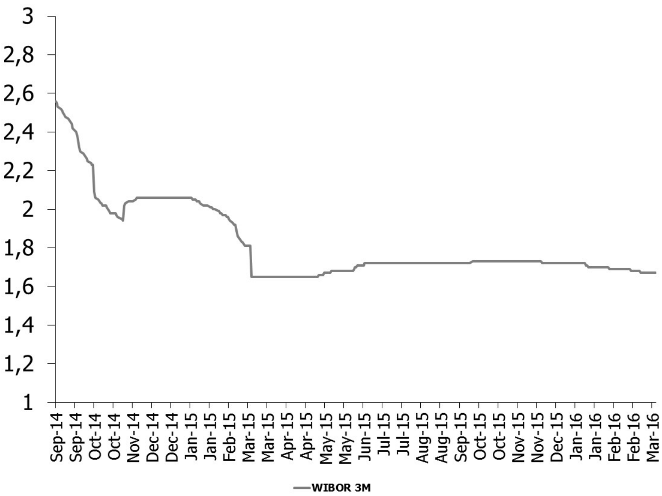
Surprisingly weak T-bill auction on Monday. Yield came out at 1.35% and what's more important, bids where less than amount offered by the Ministry. Probably two factors are to blame: hawkish MPC statement on last meeting and lack of demand from ALM desk converting cash into govvies.

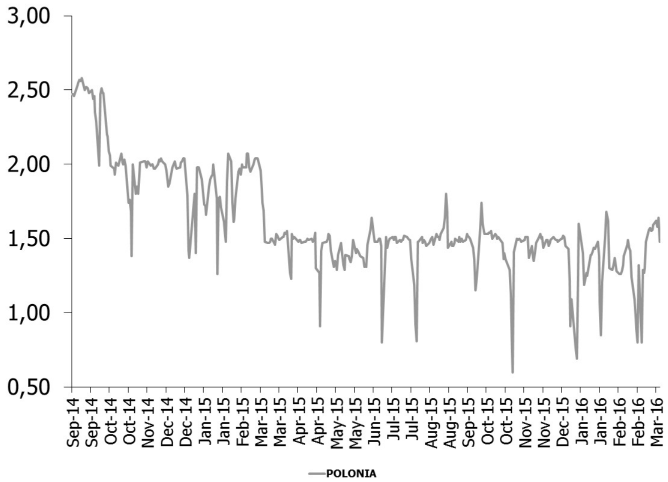
Last two weeks reminded us that cash can be higher than reference rate. Average ON for 7 previous days came out at 1.58% and we had a mini squeeze just when everyone got convinced it will be cheap now forever. What's proven right is high volatility after banking tax introduction.

Polonia vs Ref rate averages: 30 day – 14bp(-5); 90 day – 17 bp(-1)





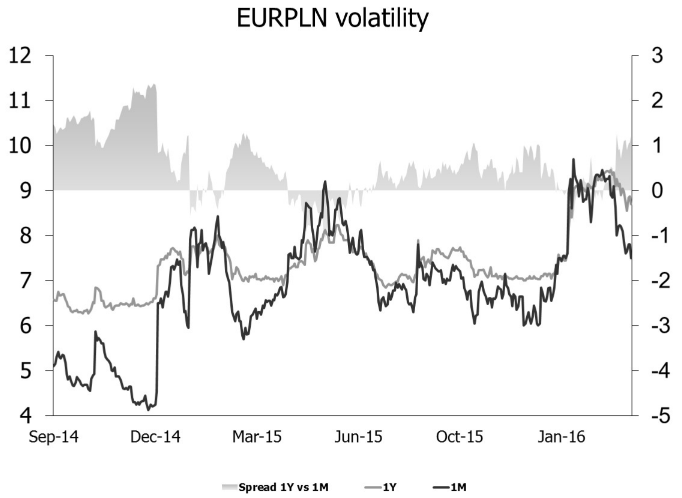




Forex

Spot – EURPLN breaking lower? EUR/PLN broke through its pivotal level at 4.2750, after FOMC has expressed its dovish attitude. It is a triple stimulus already, with ECB and MPC also being on the dovish side. As a result, the "risk on" mode is well supported. The big question is: does it have legs to go much further? In Zloty space, we are a bit skeptical. The political situation remains blurred at best with potential sources of problems firmly in place (i.e. Constitutional Court, CHF legislation draft). We expect dovish bombshell to fade with time. Expected new (shifted lower) range at 4.23-4.33.

Options – EUR/PLN Vol curve weaker a bit (again) Rather slow week for PLN Vol market, sellers of Vega had a upper hand, but the premium between realized and implied volatility is getting thinner and thinner. 1 month EUR/PLN ATM mid is today at 7.4% (0.35 % lower), 3 months are 7.90 % (0.1% lower) and finally 1 year is fixing at 8.9% (unchanged). Skew is roughly better offered, and currency spread (difference between USD/PLN vol and EUR/PLN vol) was also for sale.



Short-term forecasts

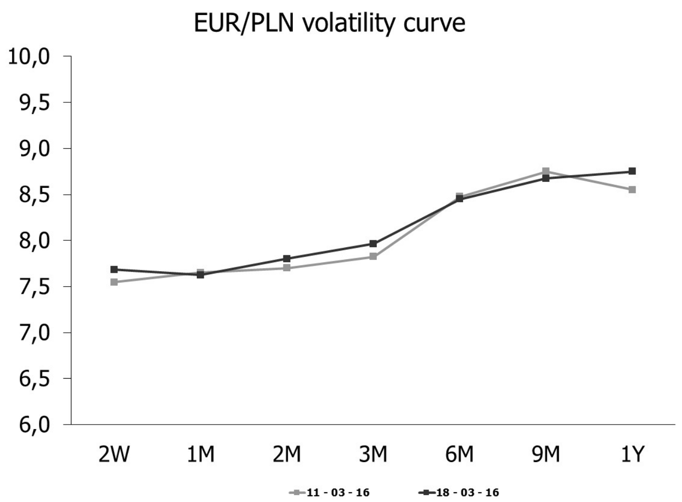
Main supports / resistances:
EUR/PLN: 4.23 / 4.33
USD/PLN: 3.72 / 3.90

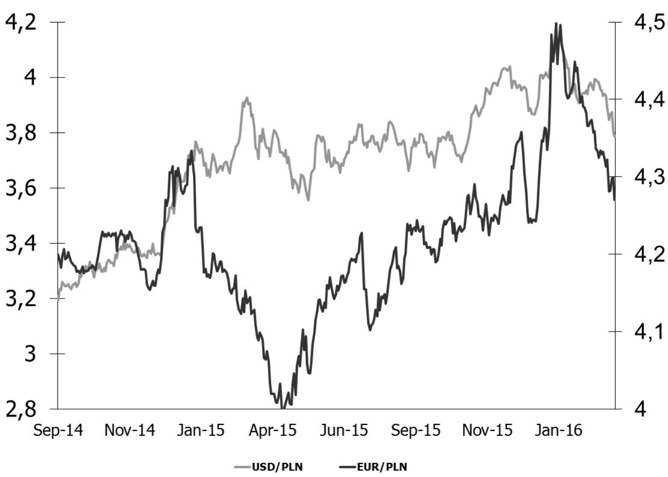
Spot Position – long at 4.3100 and 4.3900 was stopped out at 4.2750; now Sidelined.

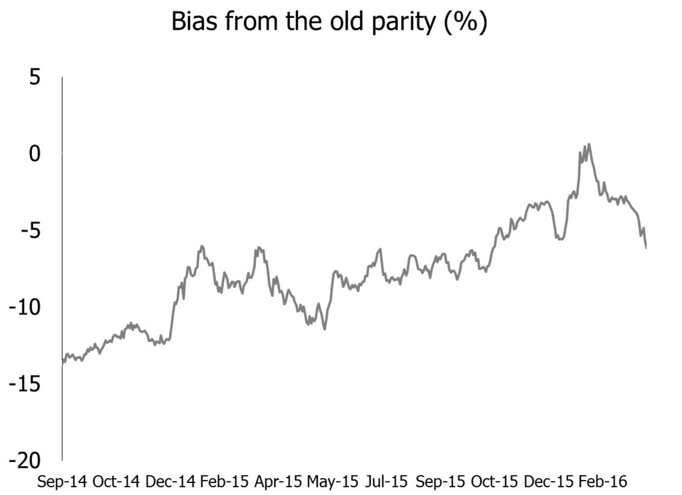
We moved to the sidelines. We have not changed our view that risk/reward is skewed to be long EUR/PLN here. But the price action proved us wrong and we have to respect that. We would try to buy EUR/PLN at 4.2300, with room to add 4.20 and stop below 4.1850 and hopes for revisiting 4.32+.

Options

We were given 1 year ATM at 8.8%. We currently have Vega neutral spread between frontend (short) and backend (long). We would be looking to close our frontend Vega, ideally at 7.5% in 3 months. We will be monitoring closely realized volatility for any base forming signals.







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
3/10/2016	1.70	1.67	1.35	1.64	1.36	1.66	1.58	1.48	1.42	1.39	1.35	1.43
3/14/2016	1.30	1.67	1.32	1.64	1.46	1.66	1.62	1.51	1.44	1.40	1.37	1.46
3/15/2016	1.41	1.67	1.45	1.64	1.45	1.66	1.62	1.51	1.45	1.43	1.39	1.48
3/16/2016	1.23	1.67	1.29	1.64	1.41	1.66	1.63	1.54	1.49	1.45	1.42	1.50
3/17/2016	1.31	1.67	1.51	1.64	1.52	1.66	1.64	1.55	1.49	1.45	1.43	1.52

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
32W TB	1/18/2016	8/31/2016	99.16	1.37	2000	11765	2400
OK1018	2/4/2016	10/25/2018	95.62	1.67	3000	8160	4645
PS0421	2/18/2016	4/25/2021	98.93	2.22	4800	9169	5143
DS0726	2/4/2016	7/25/2026	94.10	3.17	3000	6661	4366

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
3/10/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/14/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/15/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
3/16/2016	1.660	1.474	1.635	1.638	1.990	2.290	2.447	2.985
3/17/2016	1.660	1.474	1.635	1.525	2.000	2.269	2.460	2.964

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
3/10/2016	7.60	8.04	8.41	8.73	8.73	2.20	0.64
3/14/2016	7.80	8.10	8.54	8.84	8.84	2.20	0.64
3/15/2016	7.80	8.08	8.55	8.88	8.88	2.20	0.62
3/16/2016	7.50	7.98	8.44	8.70	8.70	2.00	0.58
3/17/2016	7.63	7.96	8.45	8.75	8.75	2.20	0.62

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
3/10/2016	4.3131	3.9320	3.9447	3.4678	1.3910	0.1595
3/14/2016	4.2813	3.8470	3.8983	3.3878	1.3791	0.1583
3/15/2016	4.2824	3.8649	3.9107	3.4169	1.3819	0.1583
3/16/2016	4.2980	3.8749	3.9192	3.4117	1.3812	0.1589
3/17/2016	4.2989	3.8037	3.9143	3.4137	1.3839	0.1589

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.