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Polish Weekly Review

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Table of contents

Comment on the upcoming data and forecasts

On Wednesday the CSO will publish lthe Statistical Bulletin along with unemployment data. The former will shed some light on last week's surprises, while the latter will probably confirm the preliminary estimate published by the Ministry of Family, Labor and Social Policy earlier this week (i.e. 9.6% in April). The MPC Minutes from May meeting will not reveal anything new regarding Poland's monetary policy.

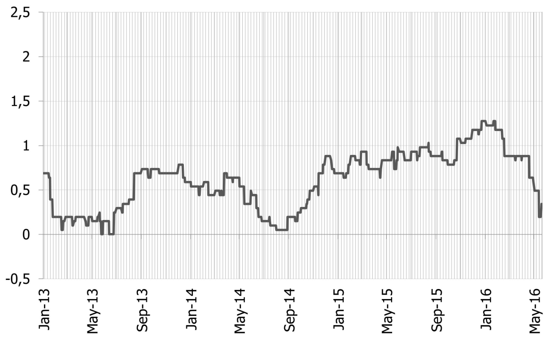
Polish data to watch: May 23th to May 27th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	25.05	Apr	9.6	9.6	10.0
MPC Minutes	27.05	May			

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	-	1500	1.645	5/5/2016
5Y T-bond PS0720	5/26/2016	4800	2.219	4/21/2016
10Y T-bond DS0726	-	3000	3.134	5/5/2016
15Y T-bond WS0428	-	20	2.092	3/12/2015

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



Comment

Positive surprises in wage growth and industrial output, and Polish surprise index is back in business. Next week, without any major publications, will not bring any changes to the 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

- 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 defensive and like 2y bonds.
- Looming event risks including negative European Commission opinion, CHF conversion bill and possible rating downgrades may negatively affect long end bonds.
- Globally we see a renewed bets on monetary tightening in the US.
- Zloty may face headwinds because of looming Brexit referendum and return of CHF-mortgage conversion proposals.

mBank forecasts

	2010	2012	2013	2014	2015	2016 F
GDP y/y (%)	3.7	1.6	1.3	3.3	3.6	3.6
CPI Inflation y/y (average %)	2.8	3.7	0.9	-0.1	-0.9	-0.5
Current account (%GDP)	-5.4	-3.7	-1.3	-2.0	-0.1	-0.7
Unemployment rate (end of period %)	12.4	13.4	13.4	11.4	9.8	8.7
Repo rate (end of period %)	3.50	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 (%)	3.6	3.1	3.4	4.3	3.0	3.5	3.8	3.9
Individual consumption y/y (%)	3.1	3.1	3.1	3.0	3.4	3.8	4.1	4.3
Public Consumption y/y (%)	1.8	0.8	0.9	8.7	3.2	2.9	4.0	4.0
Investment y/y (%)	11.8	5.8	4.4	4.4	-1.0	2.0	3.0	4.0
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	-0.9	-0.9	-0.6	0.6
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	1.67	1.66	1.44	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.62	1.45	1.35	1.30	1.30
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	2.84	3.00	3.00	3.00
EUR/PLN (eop)	4.07	4.19	4.25	4.26	4.24	4.35	4.25	4.20
USD/PLN (eop)	3.80	3.76	3.80	3.92	3.73	3.82	3.79	3.82

F - forecast

Economics

Moody’s confirms Poland’s rating but lowers the outlook to negative

The decision to cut outlook was motivated by two main factors: (1) fiscal risks associated with approved (child subsidy scheme) and planned (lower retirement age) increases in government expenditures; (2) deterioration in business environment due to less predictable legal and regulatory framework. Well-known issues such as CHF loan conversion and Constitutional Court crisis were explicitly cited. Moody’s stressed the importance of foreign financing for the Polish economy and thereby risks from bond outflows in the first months of the year. Moody’s decision is a clear indication that risk factors were identified and when those risks materialize, there will be a case for a rating cut. The key issues are CHF loan conversion, retirement age and the Constitutional Court. Moody’s will publish another review of Poland’s rating on September 9th. Reviews from S&P and Fitch will happen earlier (July 1st and 15th, respectively).

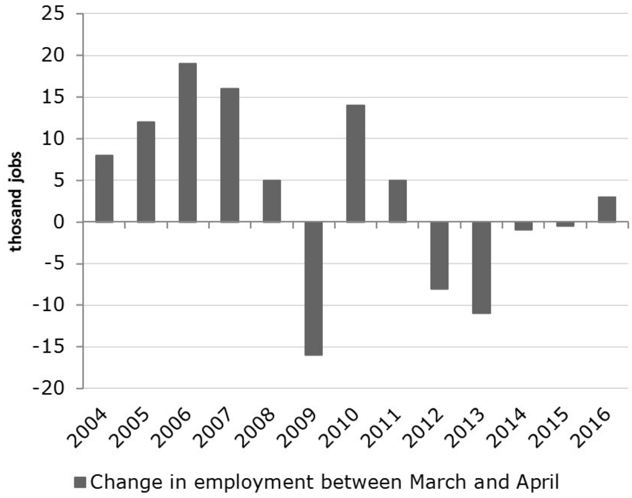
Some of the above mentioned risk factors are clearly event risks and markets are well aware of their disruptive effects. The uncertainty also means that the relief rally was short-lived and shallow. Risk premium embedded in Polish asset prices must necessarily remain high. Thus, we remain defensive regarding the Polish bond curve and stick to 2Y bonds.

Filtering signal from noise in monthly real sphere data: nothing really changed in April

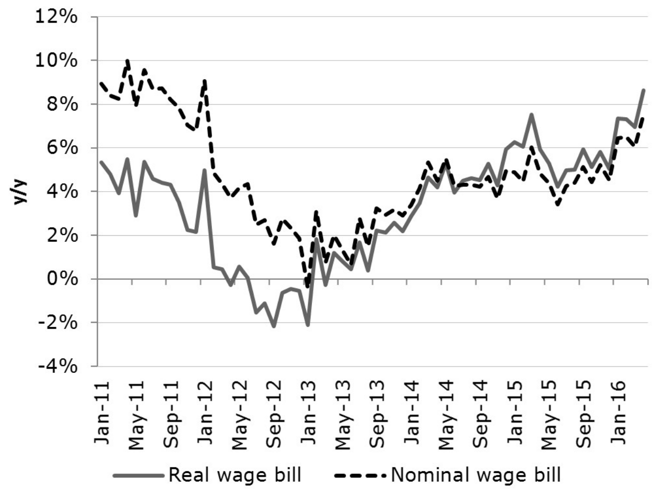
As we expected, the latest batch of monthly data showed a strong rebound in economic activity in April. But just as March data was severely distorted by the timing of Easter and other effects, April readings are biased in the opposite direction. The underlying trend is one of modest growth and the only constants in this noise are: the terrible state of construction and steady acceleration in household income and spending. In short, yet another piece of evidence on the shift from investment to consumption this year. What will the MPC make of this? Poland is definitely not overheating and deflation remains the problem right now (the alleged mismeasurement in Polish CPI is a red herring). While the MPC is preoccupied with other issues, e.g. co-op banks and market turmoil, the case for rate cuts is intact.

As usual, below you’ll find our take on each of this week’s publications.

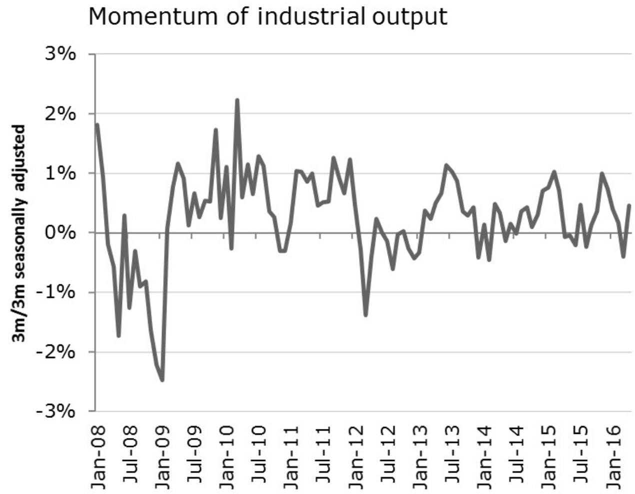
Employment in the enterprise sector rose in April by 2.8% on a yearly basis, in line with market consensus and slightly less than we forecast (+2.9% y/y). On a monthly basis 3k jobs were created, which is still a quite high given negative seasonal pattern visible in April in last years. Labour market accelerated rapidly at the turn of the year and the composition of employment growth does not look like a one-off (large increases in manufacturing, trade and transport). Thus, we do not think that after one miss we will change our views on this phenomenon. Given recent NBP business cycle indicators as well as a huge move from the so called ”junk” contracts to full or part time employment, we will be still betting on positive surprises in this series.



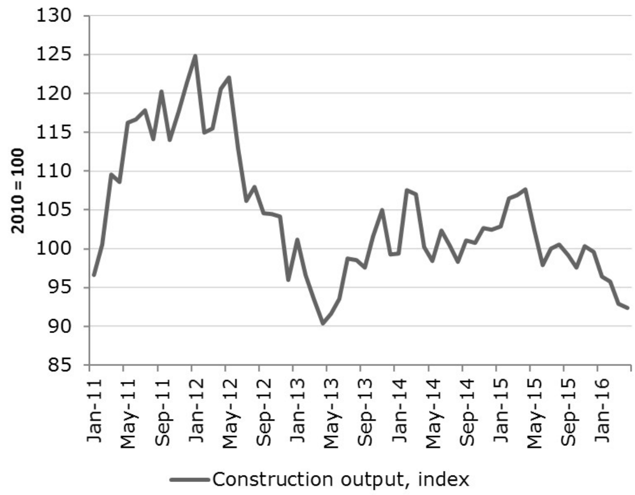
In April, average **wage growth** surged from 3.3 to 4.6% y/y, beating estimates (consensus 3.8%) and our already optimistic forecast (4.1%). As usual, not knowing the details, we are forced to speculate on the sources of the surprise. In our view, the acceleration can be traced back to two factors: (1) low statistical base in manufacturing with a possible addition of catching up after a very poor March (in that case output should also surprise to the upside); (2) strong growth in biggest service categories that already exhibited strong wage growth this year (trade, transport, hotels and restaurants). Note, however, that the bigger picture is more important, and the big picture is that wage pressures are emerging in the Polish economy. All the ingredients for wage growth have already been present for some time but the child subsidy programme might turn out to be the final straw as it puts pressure on employers to incentivize employees to remain at work.



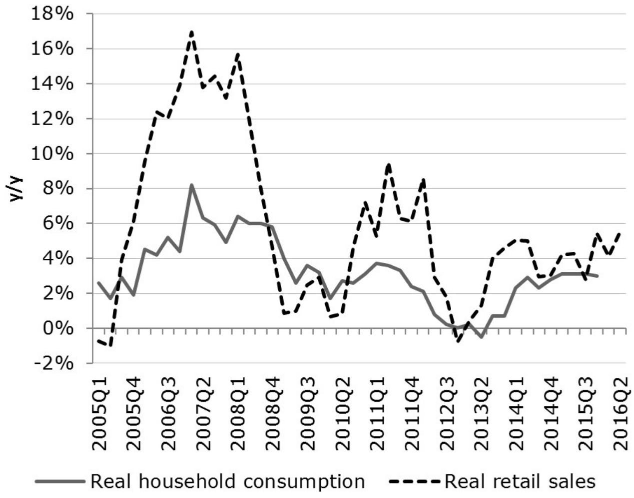
April brought a strong rebound in **industrial output** – the acceleration from 0.5 to 6.0% y/y is particularly impressive since working day difference was unchanged from March. The weakness and the subsequent rebound is a direct result of early Easter and low statistical base from last year. Seasonal adjustments don’t change the broader picture (acceleration from 0.8 to 5.7% y/y). Our favorite momentum measure also rebounded to early-2016 levels and it seems that the overall trend is more or less intact.



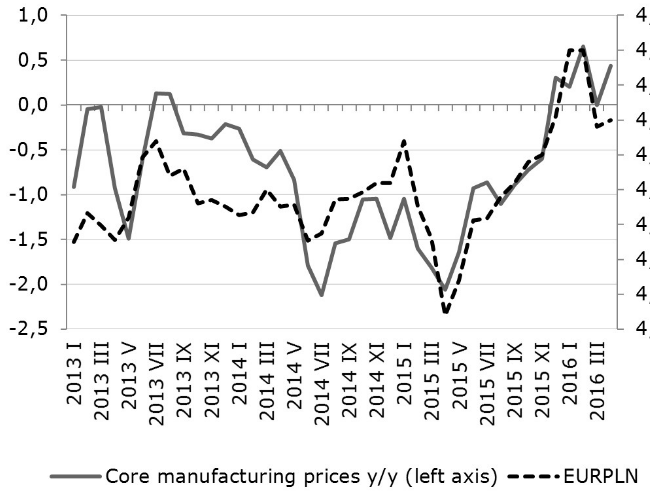
Construction output fell by 14.8% in April (on a monthly basis it fell by a seasonally adjusted 0.6% - fifth monthly decline in a row), vanquishing hopes of a stronger rebound. On the contrary – construction output is now only slightly above the previous cyclical low for the sector (Spring '13). Detailed quarterly data is of course unavailable for now but we can make an educated guess that construction output was dragged down by three main types of investment: railways, pipelines and power lines, buildings and structures for sports, culture and recreation. The common factor here is public investment and thus we see the catastrophe in construction as confirmation of our forecast of a large decline in public investment this year.



Retail sales grew by 3.2%, in line with our forecast. It seems that the theory about postponing spending just before Easter and first handouts from 500+ programme works. However, the latter would be verified later. Retail sales is catching up in the categories of clothing (from 0.8% to 1.8%), electronics (14.5% against 0.3%) as well as press and books (6.3% after -0.9% in March). Positive temporary gyrations (resulting mainly from the timing of Easter) in food and unspecialized shops categories are already gone, while car sales are still accelerating (already 17% annually). Recent data confirm that Polish consumer is alive and kicking (or spending if you wish). The 500+ programme is set to strongly support retail sales from May onwards. We calculate that 2-4pp. to growth rate can be easily generated via this channel.



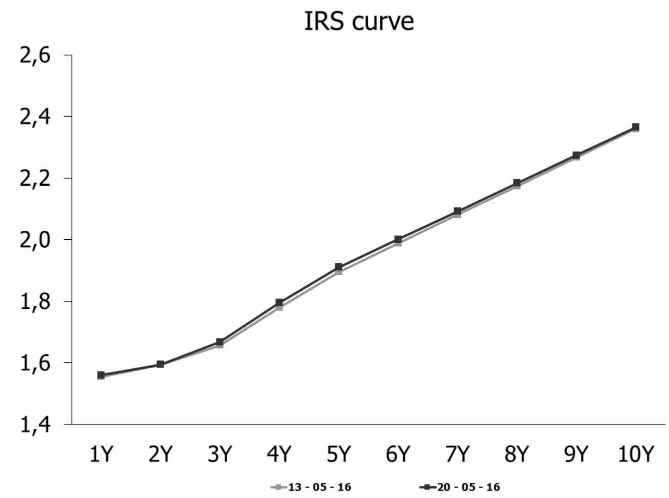
Producer prices fell by 1.2% y/y (as we forecast). The acceleration from -1.9% (downward revision from 1.7% announced before) stems from manufacturing amidst falling prices of utilities connected with gas tariffs cut. Manufacturing prices alone rose by 0.4% m/m although all of it stems from coke and oil prices (6% m/m). Excluding these makes manufacturing prices flat at 0% and annual growth reflects only exchange rate movement (see the graph). Deflationary equilibrium is still in place. As soon as recent (price) positive factors dissipate (EURPLN, oil prices), producer prices are set to return to declines.

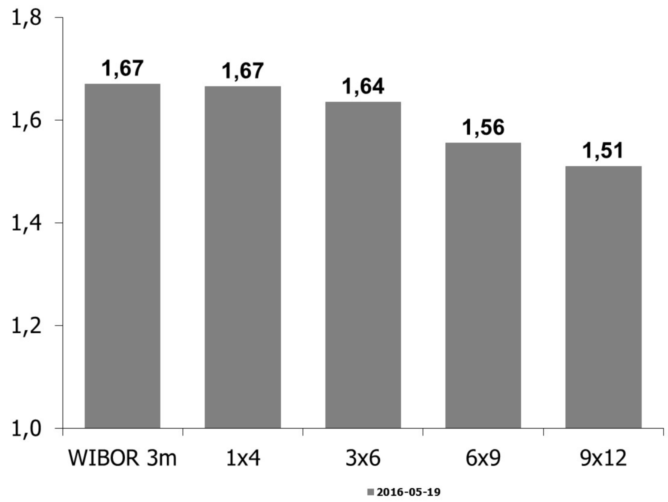


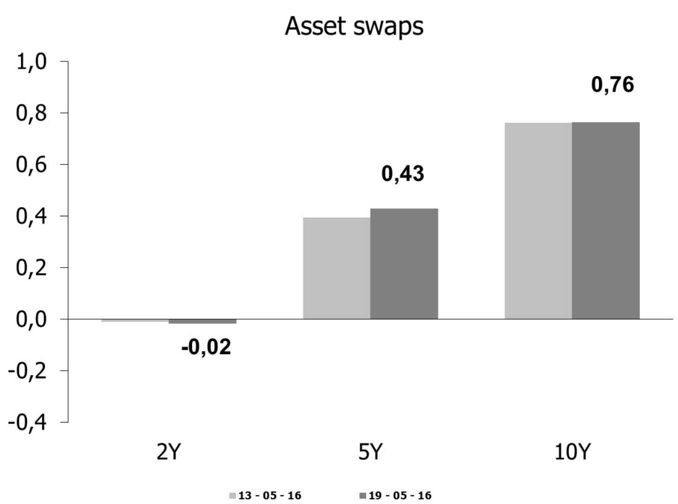
Fixed income

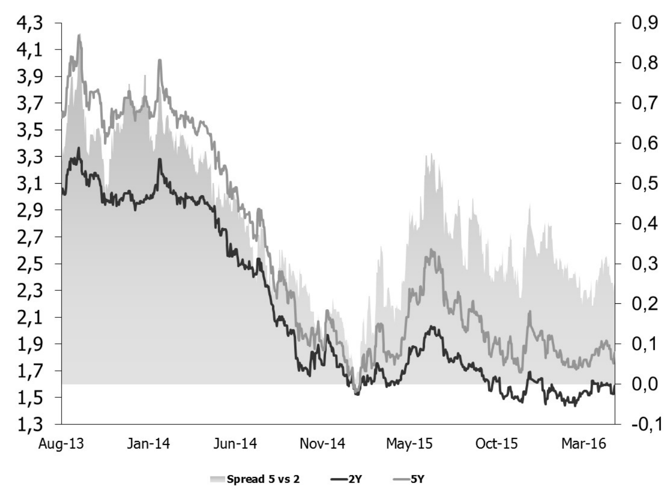
Sign of relief?

Happy those who believed in Moody's moderate stance. Fortunately, the market speculation on credit downgrade did not bring any harmful risk to the overall liquidity and asset valuation. Unfortunately, given the lack of any solid story that might help move this market towards developing to any particular direction, we were sentenced to be imprisoned in the next narrow trading range without any prospects. Though we think the risk-reward profile favors the bear market in the mid-term (accumulation of both negative internal and external events) we would go for steeper curve and more volatility as a sort of more defensive strategy.







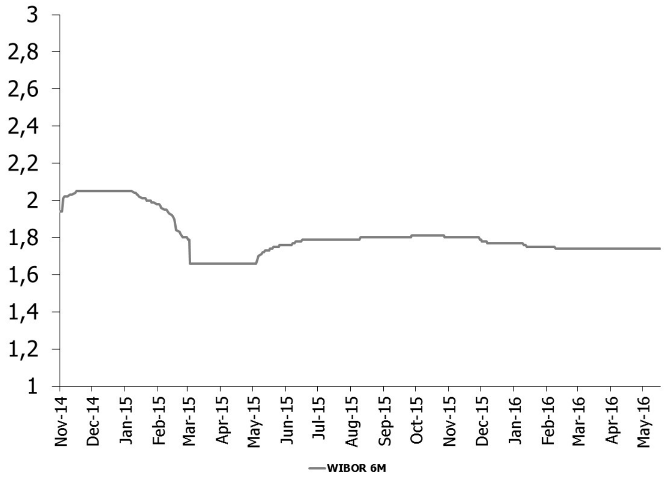


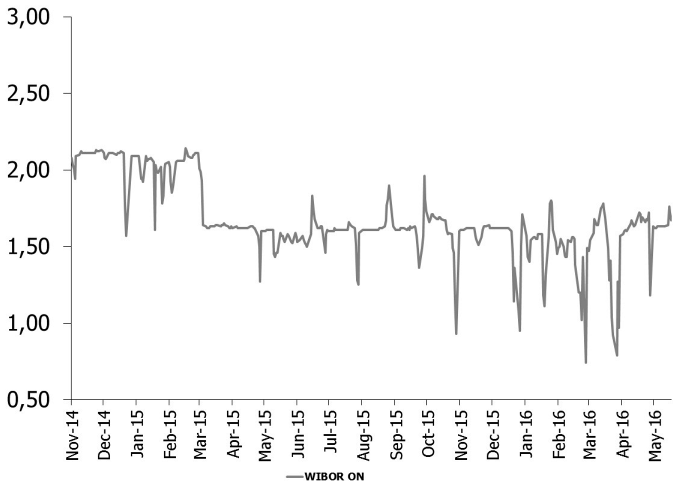
Money market

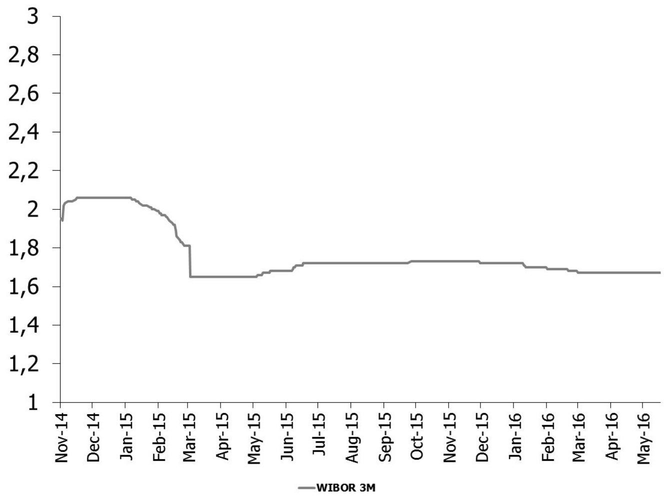
Stable week behind us

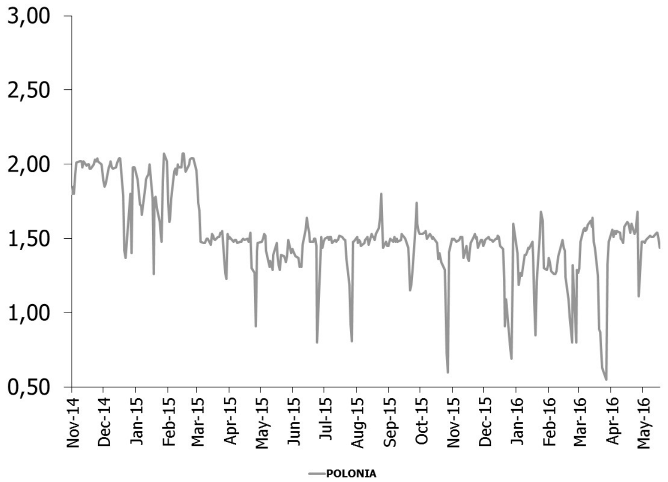
Polonia fluctuated around 1,50, falling down to 1,44 yesterday. As today's OMO was underbid by 5 bn, next week should be a bit cheaper with cash rates between 1.40 and 1,50.

Shortest bonds were massively offered last week. PS0417 was traded at 1.43, which in our opinion is a good level to buy. It's a good asset in case of potential rate cuts. On the OIS curve we noticed some paying interest on the longer end. 1Y OIS is now at 1,30, discounting 15 bps rate cut during late autumn.





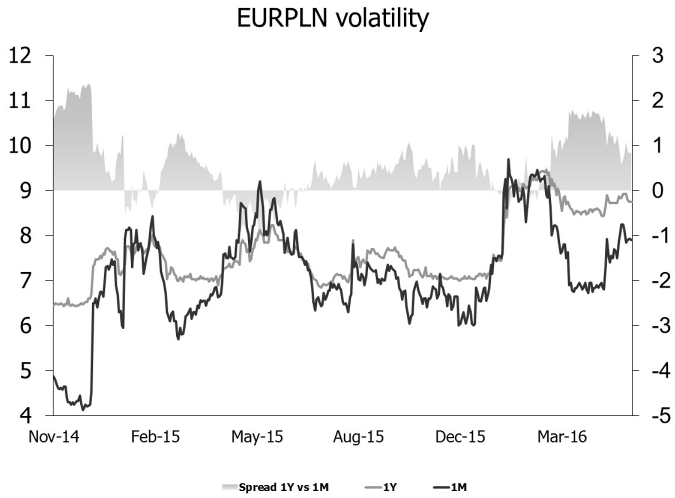




Forex

Spot – PLN still being shaky Moody's has been gentle to Poland, the cut to outlook was a positive surprise to the market. As a result, EUR/PLN has dropped to 4.3550 (week low) . The warning from Fitch, and above all, more hawkish minutes from Fed, were responsible for EUR/PLN climbing back to 4.4190 (high of the week so far). We expect more rangy price action for time being, namely 4.36-4.44. We are currently more neutral, or even a little skewed to sell tops. Because of Moodyâ€™s inaction and better macroeconomic figures that make future rate cuts less likely.

EUR/PLN vol roughly unchanged We have been better offered when PLN was shining, then it revered because of PLN losing ground again. All in all, we are roughly unchanged. 1 month EUR/PLN ATM mid is this Friday at 7.6% (0.1% lower), 3 months EUR/PLN is 8.3% (0.05% higher) and finally 1 year is 8.75% (unchanged). The skew is slightly bettered offer and currency spread (difference between USD/PLN and EUR/PLN vol) was better bid due to renewed hopes of Fed action.



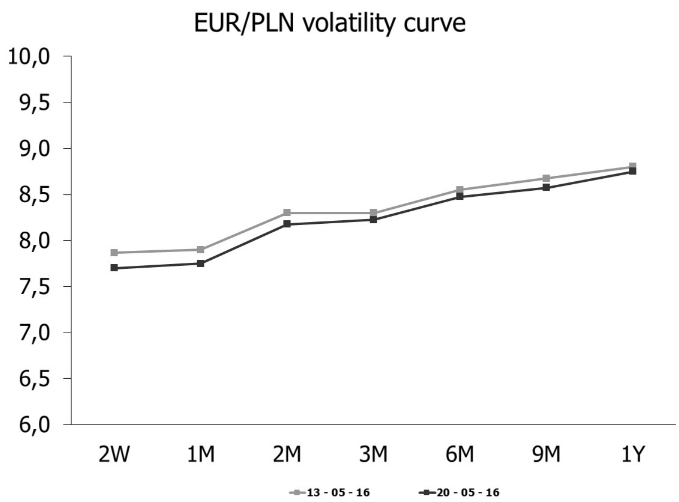
Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.35 / 4.45
USD/PLN: 3.70 / 4.00

Spot Longs EUR/PLN from 4.4050, and 4.3650 were closed with profit at 4.4100.

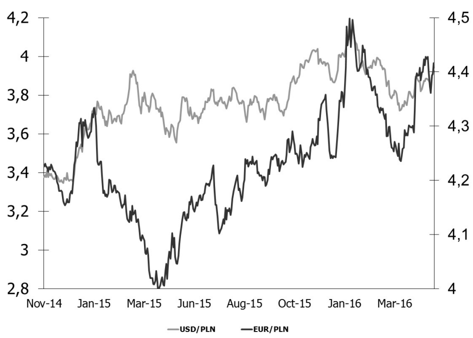
Current position: EUR/PLN short at 4.4150. we are ready to add 4.4450 with a stop above 4.4650 and hopes to see it lower, ideally below 4.35.

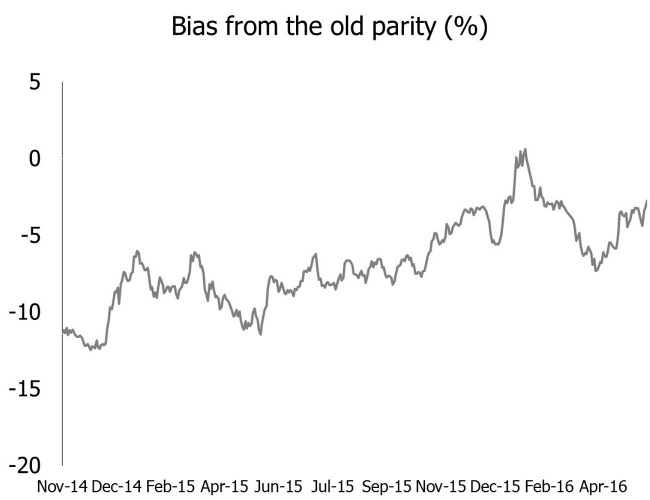
Moody's inaction did the trick, even if they eventually cut the rating in Autumn it will be hardly a shock. The CHF loan conversion project is still the biggest threat to PLN, but seems like it got watered down at least for time being. Macro seems to be little more supportive for PLN, and not signaling any push to cut rates. As a result we are opportunistically PLN long.



Options Vols – Long Vega in the backend

Our call for long backend still holds. It is bit less attractive the a few weeks back, but we cling to it. The reasons are simple, high bid/offer spread. Illiquid nature of EUR/PLN vols market, are not at all in favor of active positions adjustments. We still see enough reasons, mostly from local politics but also FED. Market structure (increased algorithmic presence), that supports holding long Vega in the backend.





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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
5/12/2016	1.72	1.67	1.50	1.64	1.50	1.66	1.66	1.61	1.57	1.51	1.50	1.59
5/16/2016	1.59	1.67	1.64	1.64	1.66	1.66	1.66	1.59	1.49	1.44	1.42	1.52
5/17/2016	1.73	1.67	1.80	1.64	1.61	1.66	1.66	1.61	1.49	1.45	1.43	1.53
5/18/2016	1.51	1.67	1.58	1.64	1.54	1.66	1.65	1.58	1.53	1.48	1.46	1.57
5/19/2016	1.77	1.67	1.82	1.64	1.67	1.66	1.67	1.64	1.56	1.51	1.50	1.57

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
5/12/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/16/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/17/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/18/2016	1.660	1.474	1.635	1.638	1.990	2.290	2.447	2.985
5/19/2016	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
5/12/2016	7.85	8.35	8.60	8.93	8.93	2.32	0.63
5/16/2016	7.93	8.30	8.55	8.75	8.75	2.32	0.63
5/17/2016	7.93	8.30	8.53	8.75	8.75	2.31	0.63
5/18/2016	7.90	8.30	8.50	8.75	8.75	2.30	0.63
5/19/2016	7.75	8.23	8.48	8.75	8.75	2.31	0.64

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/12/2016	4.4275	3.8811	4.0008	3.5621	1.4040	0.1639
5/16/2016	4.3727	3.8625	3.9577	3.5496	1.3869	0.1617
5/17/2016	4.3610	3.8508	3.9361	3.5127	1.3852	0.1614
5/18/2016	4.3937	3.9005	3.9660	3.5626	1.3922	0.1626
5/19/2016	4.3960	3.9161	3.9693	3.5574	1.3909	0.1626

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