mBank.pl

June 3, 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

Our view in a nutshell page 2
Economics page 3
■ A temporary blip in Q1 GDP growth confirmed. Inflation failed to accelerate in May.
Fixed income page 5
■ Local risk, global relief
Money market page 6
■ Rate hikes coming?
FX market page 7
■ Spot – PLN consolidating
■ Options – EUR/PLN vol lower

Comment on the upcoming data and forecasts

On Wednesday MPC will decide about interest rates. We expect the main rate to remain at 1.50%. There are various reasons for it: 1) GDP slowdown is viewed as temporary and growth should accelerate in next quarters driven by private consumption; 2) according to MPC, deflation has yet no negative impact on companies and its depth is caused by pass-through effects; 3) lower interest rate could cause systemic risk (mainly for cooperative banking sector). Finally, this is the last meeting with Prof. Belka as governor – Prof. Glapinski replaces him on 11th July. However, because of macroeconomic environment (low inflation and relatively low GDP growth), we still see risk of downward rate correction in the second half of 2016. On Tuesday we will hopefully know more about incoming CHF loans conversion proposal, since presidential committee that is addressing this matter is set to start discussing the proposal with the banking sector. However, final proposal will be most probably be presented about 15th June after substantial toing and froing.

Polish data to watch: June 6th to June 10th

Publication	Date	Period	mBank	Consensus	Prior
MPC Decision (%)	08.06	June	1.50	1.50	1.50

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	6/9/2016	1500	1.645	5/5/2016
5Y T-bond PS0720	6/27/2016	4800	2.219	5/25/2016
10Y T-bond DS0726	6/9/2016	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

Another negative surprise in CPI inflation (flash estimate) together with no upward revision of GDP growth brought the index down again. Better than expected manufacturing PMI was not enough to cause an upward move. Next week will not bring any changes, because the MPC will make no move.

* 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

- 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 fuelled 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 are negative on POLGBs
- The sentiment towards Polish assets (including bonds) might deteriorate further in the coming weeks. The principal reasons are: Fed's renewed push for rate hikes and the risk of Brexit. The on-going reallocation from low beta EMs (CEE countries) towards high beta EMs. Divergence between US and EZ monetary policies will also play a role.
- Locally, we are under an impression that the de-escalation of risks is in wishful thinking state. A new CHF loan conversion proposal itself could be a negative catalyst for the market. Stubborn MPC rhetoric makes the issue of rate cuts dead for now (for a few months).
- Zloty may face headwinds because of looming Brexit referendum and return of CHF-mortgage conversion proposals. The balance of risks favour higher volatility and the upside pressure in EURPLN.

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

mBank

mBank.pl

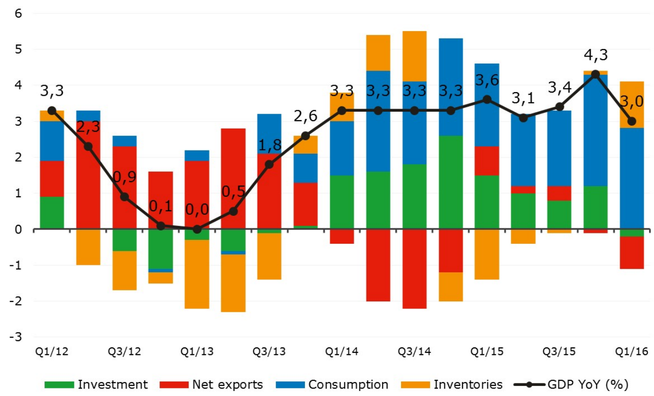
Economics

A temporary blip in Q1 GDP growth confirmed. Inflation failed to accelerate in May.

Preliminary GDP data confirmed the flash estimate of 3.0% y/y in Q1. Recent bout of high frequency data suggest acceleration from the poor start of the year has already happened. Recent PMI behaviour only corroborates the fact. At the same time, though, inflation fails to accelerate notably rising in May only to -1.0% y/y (flash estimate). We still see the risk of rate cuts this year. The depth and persistence of deflationary processes, as well as global risks, point to more easing ahead but the MPC seems preoccupied with financial stability issues. We can hardly argue with that in the short run. Looking beyond, where will the optimal interest rate be if the CHF credit conversion is completed (we fear the events leading to conversion and market reaction though) and systemic risk from the banking sector evaporates? Lower than currently, for sure. How about private investment staying subdued despite higher consumer spending? It should be also viewed as risk. That is why we do not abandon the risk of rate cuts.

Let's take a quick look at recent publications.

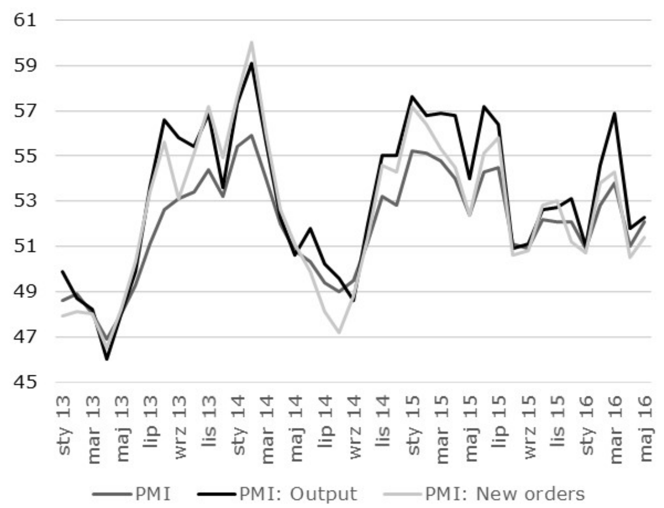
GDP. Private consumption growth accelerated in Q1 from 3.0% to 3.2% y/y, which is consistent with a slight acceleration of real retail sales. However, taking into account record-high consumer confidence, one could argue that this result has not live up to the hype. Key factor for our consumption boost scenario – government child subsidy programme "Family 500+" – has only kicked in in May (by the end of the month ca. 2 bio PLN would be distributed). Thus, the second quarter would bring a breakthrough for private consumption and further acceleration.



The behavior of investment is hardly surprising with a drop of 1.8% y/y. With a decline on a quarterly basis, this makes the Q1 2016 the worst since early 2013. The reasons for the weakness in investment are numerous and well-known. The crash in public investment (local governments, railways) is one reason, higher uncertainty and its impact on investment plans is a second factor (as seen in quarterly enterprise surveys conducted by the NBP). Finally, high statistical base in energy investment likely weighted negatively in the number as well. In such an environment the only reason domestic demand did not crash was an unexpectedly high contribution from inventory change: +1.3 p.p. We can only speculate on the nature of anti-cyclical behaviour of inventories – perhaps it is a result of cheap commodity accumulation, perhaps a result of unanticipated decline in demand.

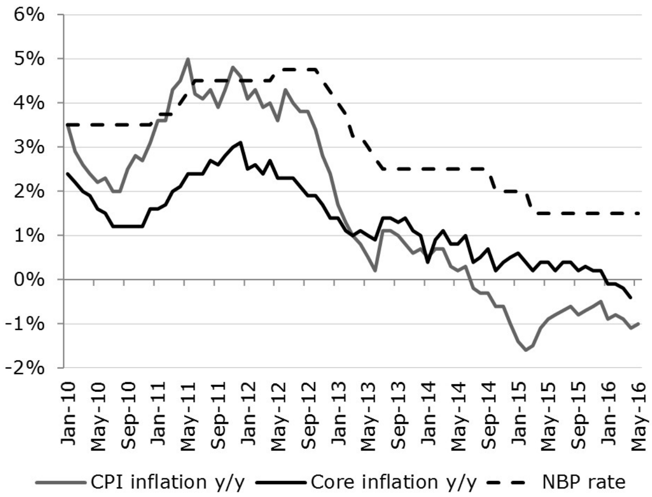
Either way, Q1 reading is a one-off and the overall trajectory of GDP will be determined by consumption and investment. Both of them suggest that growth will accelerate in the second half of the year. Consumption will of course be the main engine of growth but the declines in investment should slow down - the key factor is how fast new EU-financed spending starts (road investment is proceeding nicely, so one can be hopeful). The reaction of private investment to higher consumer spending and the government policy (and to long term strategies of Polish development, already forged under the aegis of Deputy Prime Minister Morawiecki) is far from certain at the moment. The baseline for all institutions is acceleration making the scope for disappointment fairly substantial.

The pulse of the economy – the PMI. This measure of business activity accelerated slightly in May from 51 to 52.1pts alleviating some of the downside pressure from last months. The improvement is seen in all dimensions (production, new orders, order backlogs ...). The reading is consistent with better but not spectacular growth in Q2 thereby fuelling current market consensus.



Interesting part of the report is the one concerning prices. Production costs rose at fastest pace since 32 months, finished good prices were only swifter before January 2012. It this inflation? Not really, in our view. Producer prices reflect mostly exchange rate movements (stripping from the effect of oil prices, the transmission of changes is 1:1) and global oil price developments. Therefore it is still adjustment. Recent episodes of such changes teach us they are usually short-lived. To make them long term we should see constant PLN depreciation and constant oil price growth. In such circumstances we would not need producer price indicators to claim that headline CPI would accelerate. It is still not the case, though.

Subdued CPI still here. According to flash estimate, inflation rose slightly in May from -1.1% to -1.0% y/y.



Our estimates indicated a slight monthly rise in food and fuel prices. Assuming it is true, this would mean that core inflation fell from -0.4% in April to -0.5% (a new all-time low). We still see pass-through from commodity price crash and lagged result of low inflation expectations.

Companies are not able to raise prices of finished goods because of a weak macroeconomic environment (structural demand shortage in Europe). In our opinion yearly inflation will return to positive territory only in last quarter of 2016 and only because of base effects.

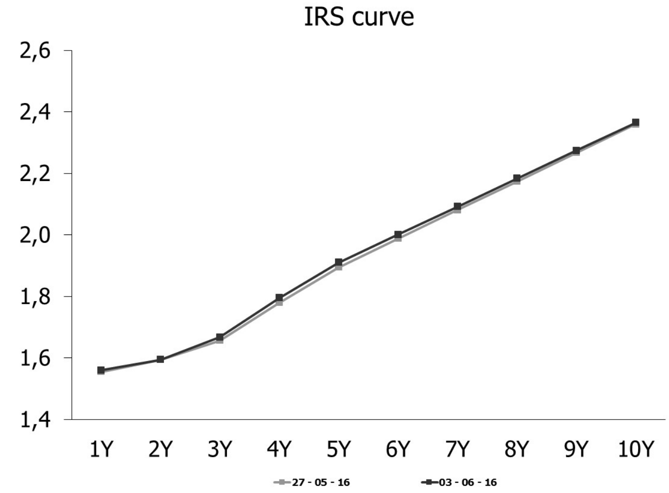
Fixed income

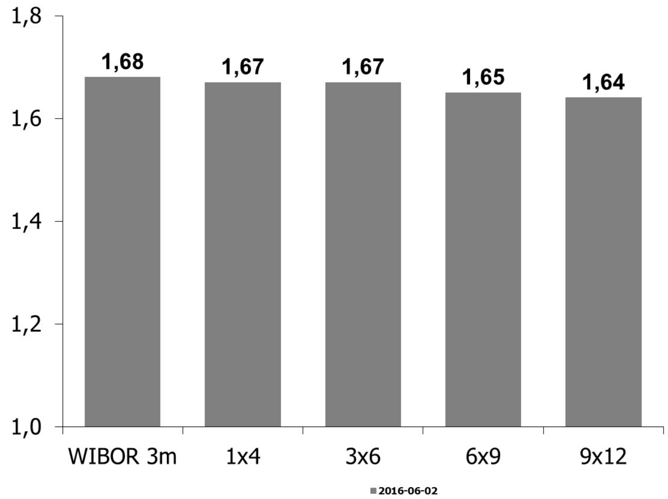
Local risk, global relief

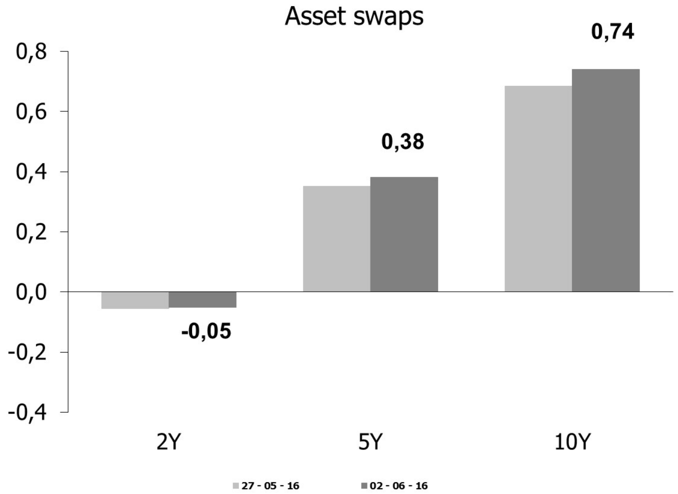
After last 5Y bonds auction market declined by few bps on the longer end, but good mood lasted only for a moment. Since the beginning of the week rates have been rising due to few factors. Firstly, market stopped to believe in any potential rate cuts as 1y3s was traded at 1.68 and 2y at 1.74 same as 3M and 6M WIBOR. Secondly, new rumours about CHF credits came out.

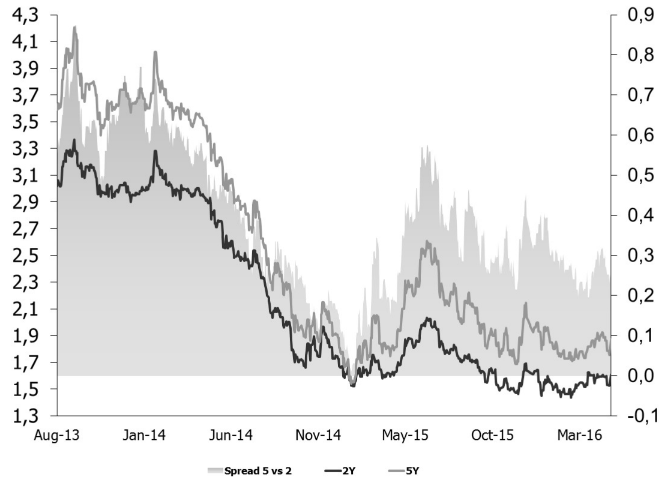
Although curve moved higher, spreads remained the same (2v5 is now around 29, 5v10 around 42.5). For the whole week we haven't noticed any bigger buying interest in mid and long term bonds. Situation changed a bit after NFP. That figure moved whole Polish curve lower by 4-5 bps. We stay defensive for PolGBs. In our opinion there are too many risks around Poland now to justify receive position. Closest possibility is the next Thursday auction with big supply of DS0726.

We also like our recommendation to buy 2v10 swap spread at 70 – 72.







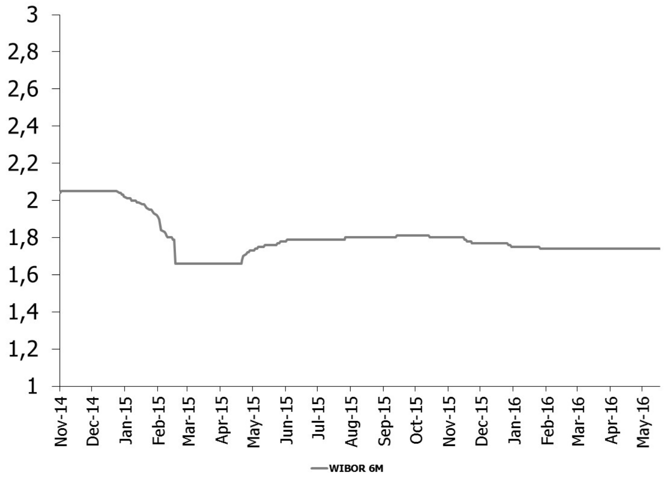


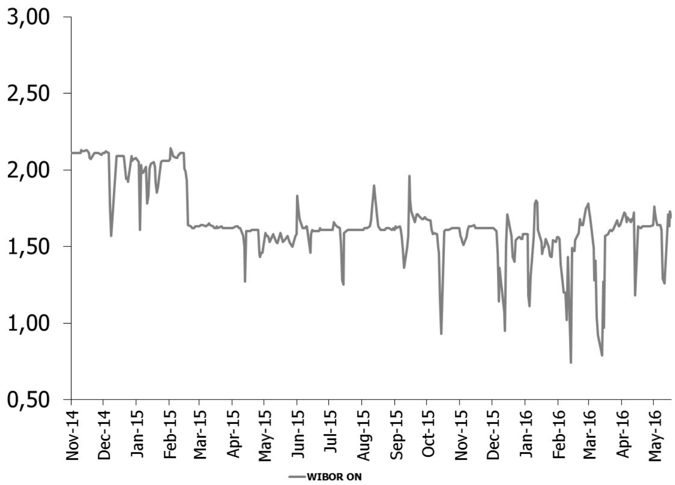
Money market

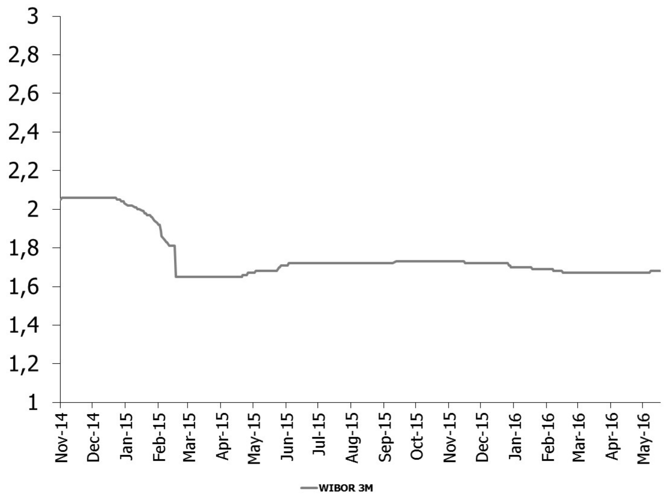
Rate hikes coming?

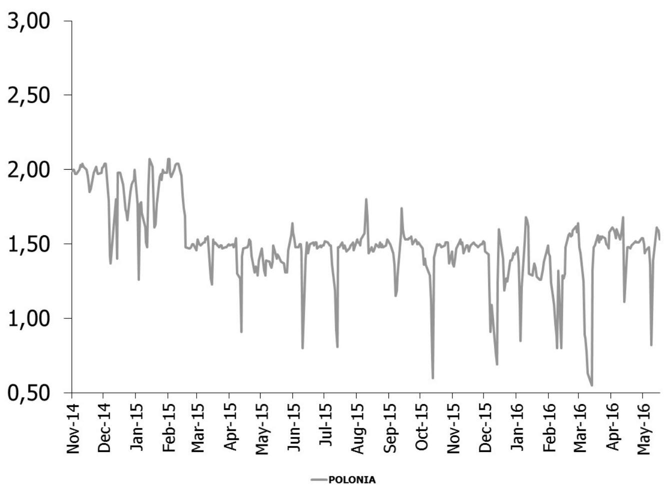
Polish market witnessed recently quite a strong sell-off. Investors have either turned bearish or at best refrained from buying. There are few reasons for this to mention. On the domestic field main concerns are CHF-loan conversion plan, pension funds reform rumours and stubborn rhetoric of MPC, which does not see chances for rate cuts. This, with addition to upcoming Fed meeting and possible Brexit has created fear among investors. As an effect, 1y3s was trading at 1.68% (same as current WIBOR) and 1y OIS at 1.40%. Concern still seems to be present on the market and upside momentum on interest rates may continue.

We would cut here any paid positions and enter receivers if fear factor continues and market starts to "predict" rate hikes.







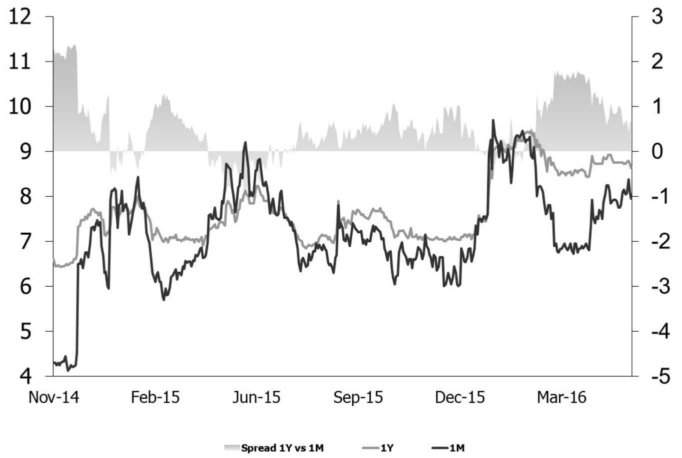


Forex

Spot – PLN consolidating EUR/PLN has been trading water lately. 4.36 – 4.46 is a wider range, but currently it is more like 4.37 – 4.43. The picture is as usually unclear, healthy fundamentals and generally solid economy are in favour of strong Zloty. On the other hand the future is painted not that bright with potential rate cuts, constitutional tribunal argument or the biggest worry of all: CHF denominated loans conversion. The ratings are deteriorating and we may expect more pain to come. We are married to our usual rangy approach but back to buying dips this time.

EUR/PLN vol lower Really low realized volatility helped to push vol to the downside (1 month was kept the same level, as it currently includes Brexit). 1 month EUR/PLN ATM mid is this Friday at 7.6% (unchanged), 3 months EUR/PLN is 7.8% (0.5% lower) and finally 1 year is 8.50% (0.25% lower). The skew is slightly better offered and Currency Spread (difference between USD/PLN and EUR/PLN vol) was once again better offered.

EURPLN volatility



Short-term forecasts

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

Spot EUR/PLN short from 4.4150 and 4.4450 was closed with profit at 4.3900.

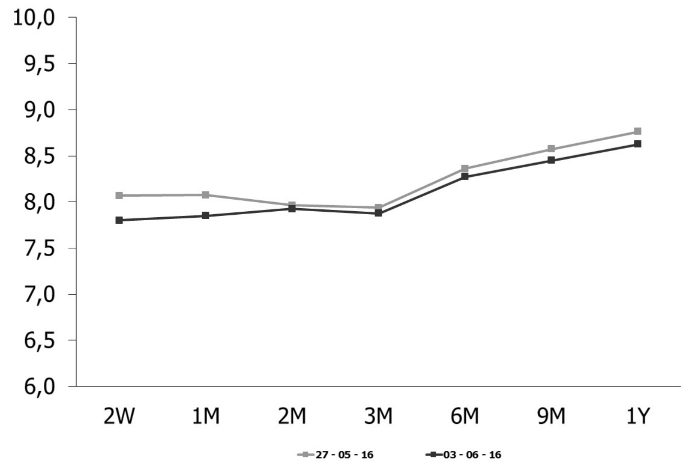
New position: We are long EUR/PLN at 4.3900 we are ready to add at 4.3600 with a stop loss below 4.3450 with hopes to test and break 4.4300 with ideal target 4.50.

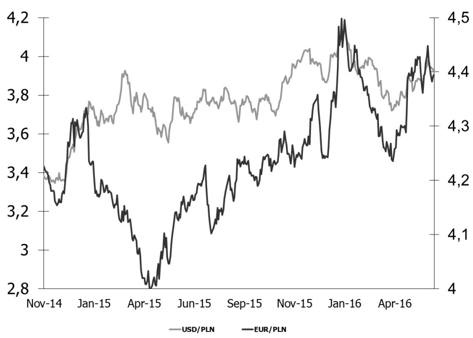
Technically we view 4.37–4.44 as a short term range. We think that being long simply translates into better risk/reward ratio. The support level is close and seems like the market is a bit PLN long. The next week calendar may include publication of new CHF conversion project by the President.

Options Vols – Long Vega in the backend

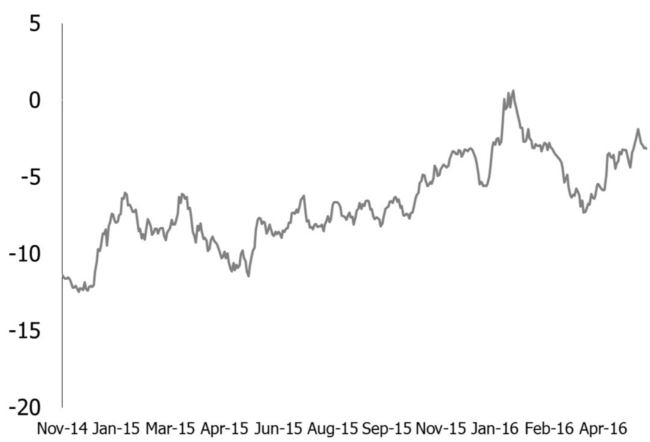
Our call for long backend still holds. It is a bit less attractive than a few weeks back but we still cling to it. The reasons are simple: high bid/offer spread and illiquid nature of EUR/PLN vols market, are not at all in favour of active positions adjustments. We still see enough reasons, mostly from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

EUR/PLN volatility curve





Bias from the old parity (%)



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
5/26/2016	1.67	1.68	1.77	1.64	1.73	1.66	1.68	1.66	1.60	1.57	1.57	1.65
5/30/2016	1.83	1.68	1.91	1.64	1.75	1.66	1.68	1.66	1.59	1.56	1.56	1.64
5/31/2016	1.88	1.68	1.94	1.64	1.77	1.66	1.68	1.64	1.61	1.58	1.60	1.65
6/1/2016	1.66	1.68	1.70	1.64	1.67	1.66	1.68	1.66	1.64	1.61	1.61	1.66
6/2/2016	1.70	1.68	1.75	1.64	1.64	1.66	1.67	1.67	1.65	1.64	1.64	1.69

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
5/26/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/30/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
5/31/2016	1.660	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/1/2016	1.660	1.474	1.635	1.638	1.990	2.290	2.447	2.985
6/2/2016	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
5/26/2016	8.05	8.10	8.43	8.73	8.73	2.45	0.67
5/30/2016	8.38	8.14	8.40	8.79	8.79	2.45	0.67
5/31/2016	8.10	8.00	8.33	8.73	8.73	2.37	0.63
6/1/2016	7.95	7.98	8.33	8.63	8.63	2.37	0.63
6/2/2016	7.85	7.88	8.28	8.63	8.63	2.37	0.63

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/26/2016	4.4238	3.9684	4.0000	3.6004	1.4058	0.1637
5/30/2016	4.3945	3.9470	3.9757	3.5515	1.3987	0.1626
5/31/2016	4.3820	3.9369	3.9701	3.5473	1.3946	0.1621
6/1/2016	4.3895	3.9350	3.9658	3.5812	1.3994	0.1624
6/2/2016	4.3944	3.9204	3.9731	3.5962	1.4014	0.1626

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.