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# Polish Weekly Review

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## Comment on the upcoming data and forecasts

Next week brings only one important publication – CSO Statistical Bulletin (on Wednesday). Besides details of last week's data, unemployment rate for May will be announced. Preliminary MFLPS data indicated that drop in this category was lower than market expected. The second publication on that day, MPC Minutes, will go unnoticed.

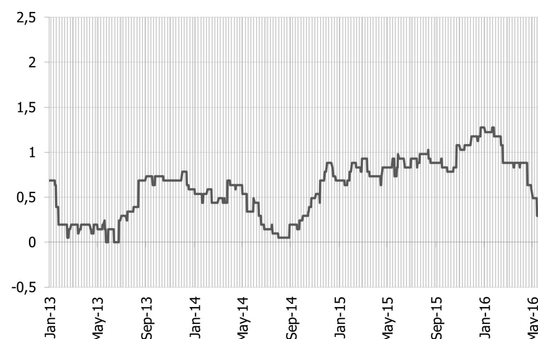
### Polish data to watch: June 20th to June 24th

| Publication | Date | Period | mBank | Consensus | Prior |
|---|---|---|---|---|---|
| Stopa bezrobocia (%) | 23.06 | May | 9.2 | 9.1 | 9.5 |
| MPC Minutes | 23.06 | Jun | | | |

### 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 | 1.708 | 6/9/2016 |
| 5Y T-bond PS0720 | 7/7/2016 | 4800 | 2.219 | 5/25/2016 |
| 10Y T-bond DS0726 | - | 3000 | 3.050 | 6/9/2016 |
| 15Y T-bond WS0428 | - | 20 | 2.092 | 3/12/2015 |

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




### Comment

Most publications surprised on the negative size but only retail sales data came significantly lower than market forecast. Thus, Polish surprise index moved only slightly down. Next week brings only one opportunity to change that, preliminary data about unemployment rate were different than market forecast.

* 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 and brisk wage growth), 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 turn bullish on 10Y Polish bonds and retreat form CASH which – in the meantime – proved to be an optimal allocation while 10Y bonds made 25bps up in yield.
- Local players (+ the most active portfolio internationals) have been stopped out, rate cuts are priced out. Swiss credit conversion scheme moved to the background (for now).
- Global environment is conductive to bets on lower growth and inflation which favors government bonds. Fed is going to be a mirror of these developments and we expect it to slowly back away from rate hikes this year. Polish growth model (more domestic demand driven by transfers) can be perceived as safe in such environment (normally growth worries are destructive for EMs).
- We believe that Brexit fears have peaked. Based on the history of previous British referenda, we judge that protest votes are peaking several days ahead of the event and then subside. This is due to the fact that some voters who claim to be for leaving the UE are in fact risk averse and eventually revert to a status quo vote (i.e. vote Remain). We are betting that history will repeat itself.
- Given its highest gear towards the risk of CHF conversion schemes (physical purchase of swiss francs by banks for clients) the zloty may be less conducive to reduction of risk ahead of the British referendum. Therefore the upside for the zloty is short-term lesser than in bonds. However, in the short-term both asset classes may reinforce one another. This way positive scenario for bonds is also a bit positive for the zloty.

### 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 | 3.2 | 3.8 | 4.1 | 4.3 |
| Public Consumption y/y (%) | 1.8 | 0.8 | 0.9 | 8.7 | 4.4 | 2.9 | 4.0 | 4.0 |
| Investment y/y (%) | 11.8 | 5.8 | 4.4 | 4.4 | -1.8 | 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 | 1.50 | 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 | 1.60 | 1.50 | 1.40 |
| 10Y Polish bond yields (% eop) | 2.31 | 3.31 | 2.84 | 2.94 | 2.84 | 3.30 | 3.15 | 3.05 |
| EUR/PLN (eop) | 4.07 | 4.19 | 4.25 | 4.26 | 4.24 | 4.45 | 4.35 | 4.25 |
| USD/PLN (eop) | 3.80 | 3.76 | 3.80 | 3.92 | 3.73 | 4.05 | 3.95 | 3.86 |

F - forecast

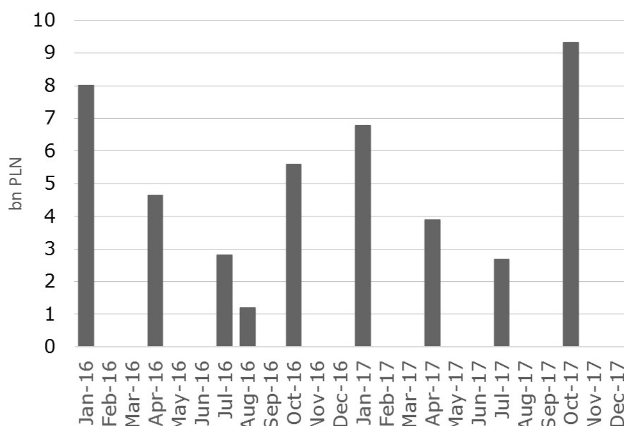
# Economics

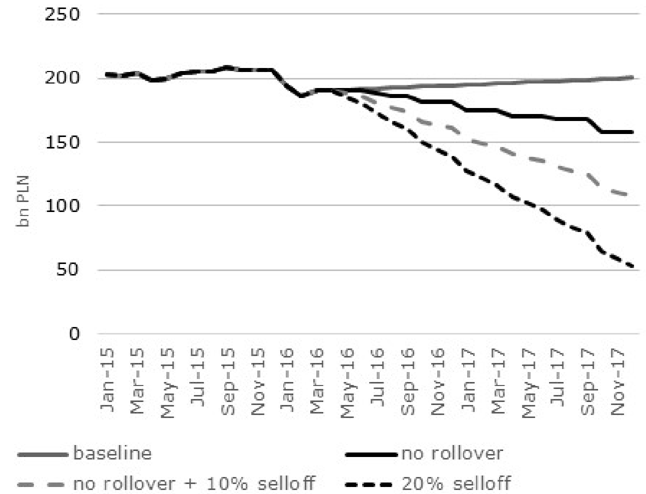
## What if they (foreigners) sell? Assessing the scope for increasing bank holdings of Polish government bonds.

As of March, non-residents held 190 bn PLN of Polish government bonds (local currency, in all maturities), making up a significant chunk of government debt in general (34% of all local currency marketable debt and 22% of total government debt). Since mid-2015, however, nonresidents' holdings declined by ca. 18 bn PLN and it is commonly feared that this trend would continue – with negative effects for debt service costs or even financial stability. Therefore, we decided to take a look at another major player on POLGB market – local banks – and see if they can take over from foreign investors. We approached this problem from few separate directions (demand and supply of bonds).

First, we used our forecasts of loan and deposit growth (as well as other items in banks' balance sheets) to assess how banks' balance size and structure would evolve. Using fairly conservative assumptions (L/D ratio to decline further, trends in most smaller items to continue unabated), we learned that bank holdings of government bonds could increase by 75 bn PLN this year and 73 bn PLN next year. We treat these as a measure of banks' capacity to purchase government bonds. In a way, it can be viewed as a byproduct of both bank tax (from which government bonds are exempt) and the redistributive agenda in economic policy. Actual purchases depend on market situation, MinFin's debt management strategy and incentives offered by the state.

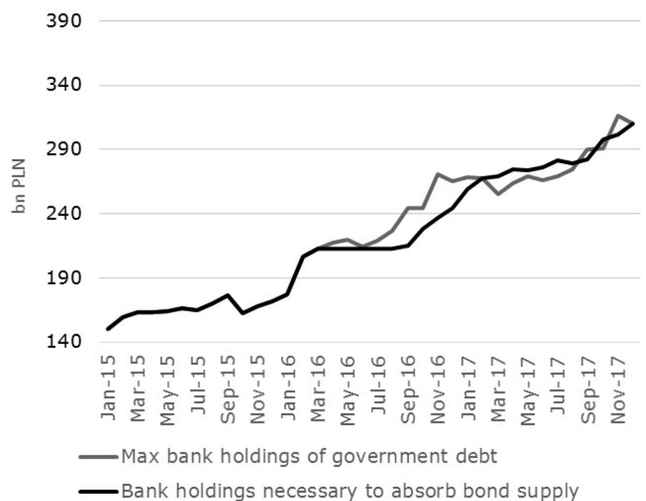
Second, while we do not know how foreign investors will behave, we can work out reasonable scenarios. The most optimistic one, given the structurally higher risk premium in Polish assets and the state of the global economy, is one of slow (3% p.a.) growth. The baseline scenario is mildly pessimistic (and close to what actually happened at the turn of the year) – it assumes that foreign investors do not roll over their holdings as they mature but do not sell POLGBs outright. The maturity profile of nonresidents' holdings is presented below. The pessimistic scenarios assume, in addition to the lack of rollover, that investors actively sell POLGBs, either 10 or 20% of initial holdings.




Third, we look at MinFin's borrowing needs which we derive from projected deficits and the maturity profile of outstanding government debt (note – we restricted our analysis to local currency bonds). Note that a significant portion of borrowing needs for this year has already been secured via prefinancing (68%) – in essence, the MinFin doesn't need to issue new debt this year. In addition, since recent issuance has been heavily tilted towards the long end, this segment is at a smaller risk anyway.

By adding the three strands together we learn that the sizeable bond-buying capacity of banks is sufficient to make up for the lost demand from foreign investors if their holdings are not rolled over in 2016 and 2017 (see the graph below). If non-residents, however, actively sell Polish government bonds, banks cannot absorb the additional supply that easily – this is where the NBP steps in. Following the footsteps of the NBH, Polish central bank can boost bank demand for government bonds by limiting the supply of NBP bills and forcing commercial banks into T-bills (thinking completely outside the box, issuer and concentration limits offer another degree of freedom in borderline scenarios and can be adjusted flexibly). In such a scenario there might be a problem of maturity mismatch (banks would buy short-term paper, non-residents would probably sell mid- and long-end bonds) but it can be handled by the MinFin.




All in all, our conclusion is an optimistic one. The Polish Ministry of Finance will not run out of buyers for bonds. It is also very

unlikely that it will face liquidity problems – the cash position of the Ministry is a very favorable one. Therefore, while the Brexit risk looms large, it will not translate into a crash in Polish budget financing.

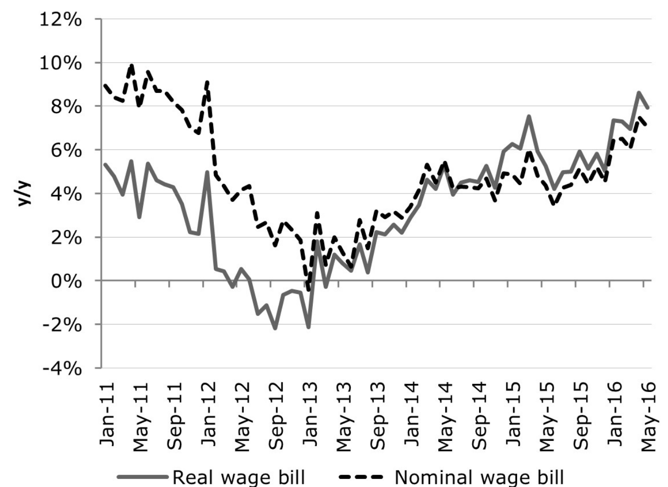
## Inflation is inching up on external factors, real sphere data remain mixed

Last week all important data saw the light. Although there are gyrations in one way or the other the big picture is still unchanged. Inflation is inching up a bit on both sides: consumer's and producer's. At the same time real sphere is showing off neutral momentum whereas retail sales stays rather disappointing due to the fact that extra money from government transfer could have been primarily spent on services. Of course such a development does not change our optimistic view on consumption as a whole; it's the composition that may be different (at least with current information set we have). Labor market is improving further with more wage growth in the pipeline. For some analysts it seems natural to expect only rate hikes now. Well, we do not agree. Recovery is still fragile, deflation still entrenched and risks connected with balance sheet adjustments of enterprises are flying high. We still strongly disagree that higher wages costs and input prices translate into higher prices and everything works fine. It may entail some gyrations on the real sphere first (layoffs, bankruptcies). Therefore, we still see a risk for rate cuts, especially given the fact, that global deflationary pressures are not abating and global growth worries recently gained strength.

Let's take a more detailed look at publications. **Employment** in the enterprise sector rose by 2.8% y/y in May, in line with market consensus and our forecast. The acceleration observed since the turn of the year is officially over and employment is now growing at a more modest pace. Two important questions need to be asked here: First question is about the shift from the so called "junk" contracts to full or part-time employment, which is visible in various labor market measures (see chart below). Is this trend already over, or is there still fuel there? This is very important when forecasting employment in the enterprise sector. From the whole economy's point of view, we are wondering if such phenomenon will change workers' position on the labor market and change their decision making process.

Secondly, what impact will both "Family 500+" child subsidy programme and higher than previously announced raise in minimal wage have? Without going into to many details this could go in one of the two completely different directions. One possibility is that employees' position on the labor market will improve, resulting just in transfers from companies to consumers, capital to labor. The second possibility is that this will destroy current market equilibrium and jump-start restructuring among the smaller corporates and SMEs (automation + elimination of least efficient companies), which will obviously have a negative impact in the short term (longer term effects are more complicated).

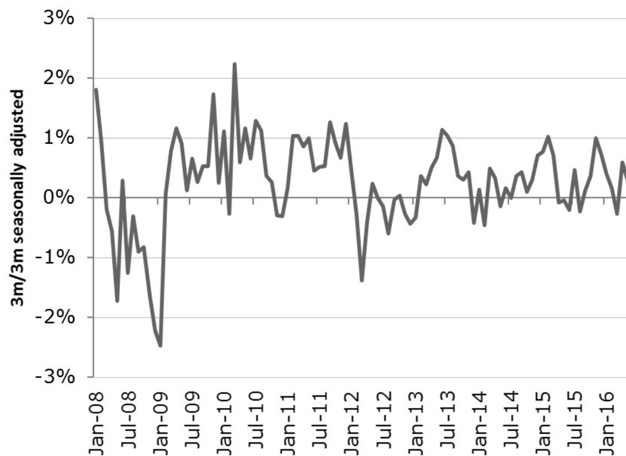
**Average gross wage** grew by 4.1% y/y, below market consensus of 4.6% and our own forecast of 4.8%. As usual, we can only speculate about the sources of the surprise. In our view, the best bet is manufacturing wages which could have been dragged down by an unusual arrangement of bank holidays last month. With ease it allowed for two "long weekends" and reduced working time, thereby putting a brake on industrial output and wages. If that is the case, it will be confirmed by industrial output data later this week. Other sectors probably behaved in line with recent trend. In particular, wages are in retail trade and services are growing fast. Those sectors are most susceptible to labor shortages due to exits from the labor force induced by the new child subsidy scheme (raising wages is thus a rational strategy for the employers). Anecdotal evidence seems to be confirming this idea.




Short-term gyrations in wage growth do not change the fact that household disposable income growth is at multi-year highs. In current prices it amounted to 7.0% last month, in constant prices – to 7.9%. Unless one makes a completely unrealistic assumptions regarding saving rates, it is impossible for this windfall not to boost consumption. Our scenario of fast household consumption growth is materializing as expected.

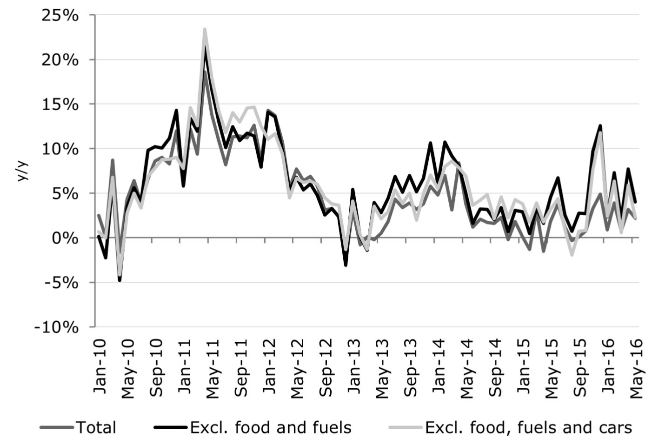
**Industrial output** grew by 3.5% y/y in May, below market consensus and our forecast (4.9 and 4.5, respectively). The slowdown itself was expected and can be traced back to an unfavorable arrangement of public holidays – this year, it allowed for longer holidays (two long weekends as compared to one in the previous year). As a result, output contracted by a modest 0.9% m/m (seasonally adjusted). With this month's data, the momentum if industrial output is consistent with 4% growth. While the above mentioned effects should be reversed in June, the overall tendency seems to be unchanged. In particular, the lack of negative spillovers from construction should be viewed

as a positive development.



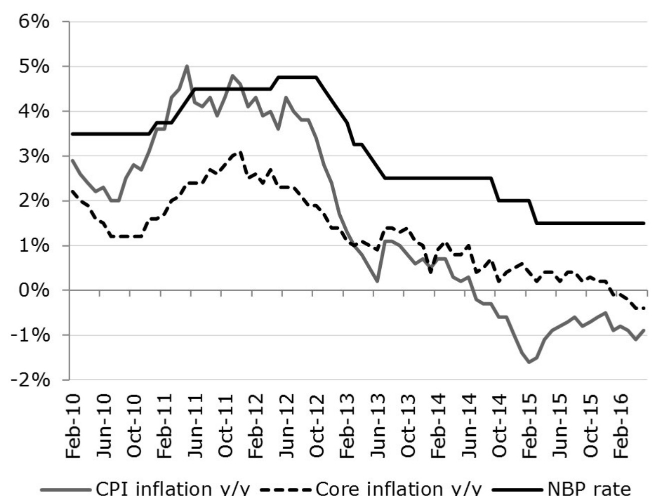

**Construction output** declined by 13.7% on annual basis, upsetting both market consensus and our forecast. There are no excuses here. This is also the sixth (sic!) consecutive monthly decline in construction output – a multi-year record. We can only repeat that the poor state of the sector is a result of drastic cutbacks in public investment, led by local governments and railways. The scale of this decline is unprecedented and it is only due to relatively robust road spending the drops in construction output aren't as deep as in 2013.

**Retail sales** rose in May by 2.2% what's been below our expectations. Since our forecast strategy allow for differentiation between recent trends, seasonality and recent boost in transfers (500+ scheme), we can safely say that the latter is rather non-existent in the data. Of course, given that retail encompasses only goods, extra money could have been spent on services or saved (what we consider unlikely given the strong bias of consumers towards consumption). Consumption's wise (that from national accounts) it is neutral development for the whole year scenario. We still think that private consumption is going to compensate for weaker investment (and in dynamic terms favor the growth of the latter, although with significant lag), although it composition is yet unknown at this stage.




**Producer prices** increased a bit and fall 0.7% on annual basis in May. It is still to early to write on any domestic price pressures building. The growth of prices stems mainly from higher prices of oil and the latter part can be attributed to weaker exchange rate. As for the latter, its track record of following manufacturing prices excluding coke and oil has proved remarkable in recent time (see the graph). The key takeaway is that we still do not see any inflationary pressure on the producer's side. Therefore higher wages and higher input prices are unlikely to transmit to producer prices before firm gain any market power and competitive forces ease. That may entail restructuring (layoffs) and even bankruptcies. The road for inflation is not going to be so straightforward and easy as some analysts suggest.

According to the final estimate, **inflation** rose slightly in May from -1.1% to -0.9% y/y. This result is slightly higher than flash estimate (-1.0%). In May food prices fell slightly (by 0.1% m/m), confirming estimates based on earlier data from Czech Republic and Hungary. On the other hand, fuel prices rose rapidly 4.2% on a monthly basis. In most categories prices remained stable, showing only small, random gyrations (prices in culture and recreation as well as in transport fell, while for restaurants and hotels they moved up). Core inflation remains at last month's levels (-0.4% yoy). We still see pass through effects of lower commodities prices, but also a drop of inflation expectations in last quarters. In current macroeconomic environment companies do not have the power to rise final goods prices.



# Fixed income

## Ahead of Brexit

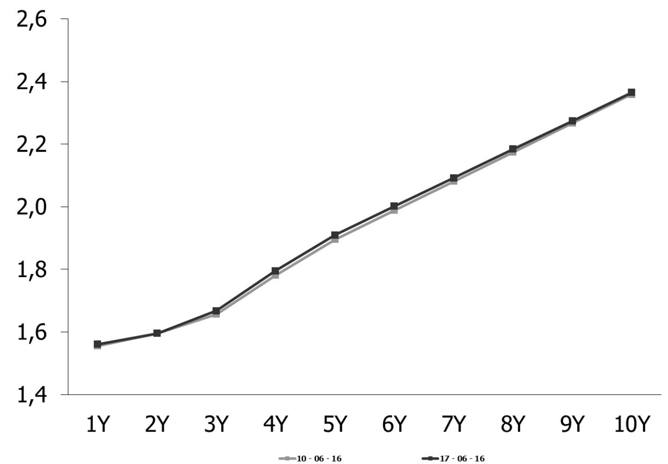
The FI market found its new driver last week. Heading closer to the UK referendum date the mixture of greed and fear determined both greater turnover and volatility. The market was focused on offsetting the risk of domestic bond holdings exposure and sold the 10y assets down to 3.30% highest from early February 2016. Surprisingly, the shape of Polish yield curve did not change much as the front end of a curve followed the move.

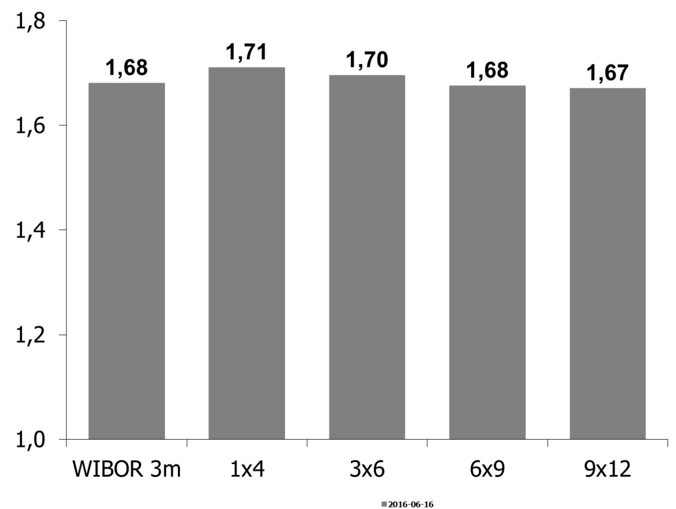
We recognize several base risks over Brexit:

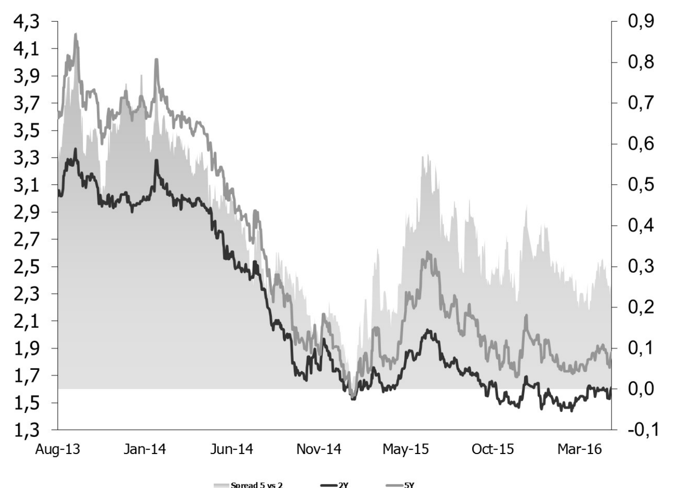
1. The risk of further assets repricing together with greater market volatility,
2. Limited or even lack of market liquidity of certain class of assets,
3. Temporal disability of financing coverage of existing bond holdings.

The last market turmoil led to one of the deepest repricing of all class of assets along the yield curve shifting risk-reward profile towards risk-on strategy. Although the positive result of Brexit voting (UK leaves EU) would definitely result in further slump of bond prices and lead to uncontrolled shift of the yield curve.

We expect the market participants to reduce their activity over Brexit voting in order to avoid the liquidity trap that might result in daily excessive losses.



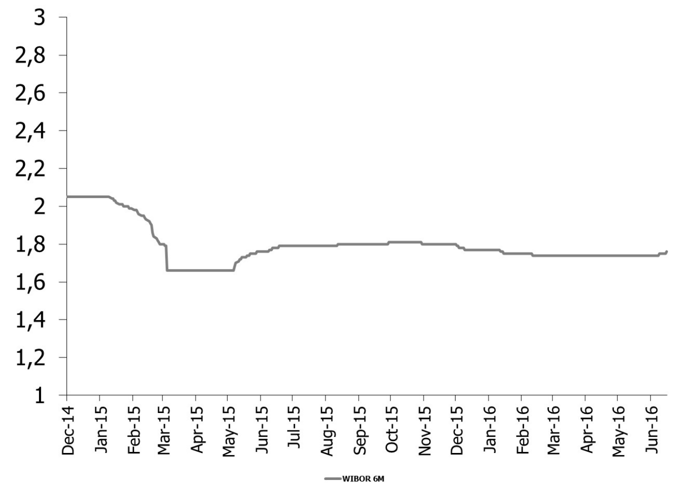



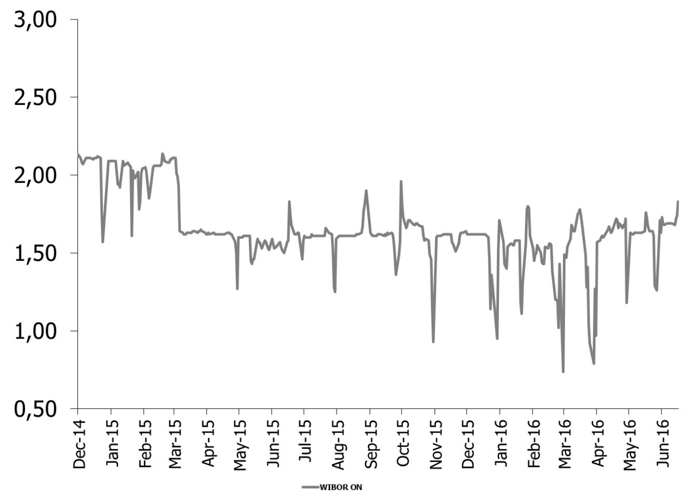



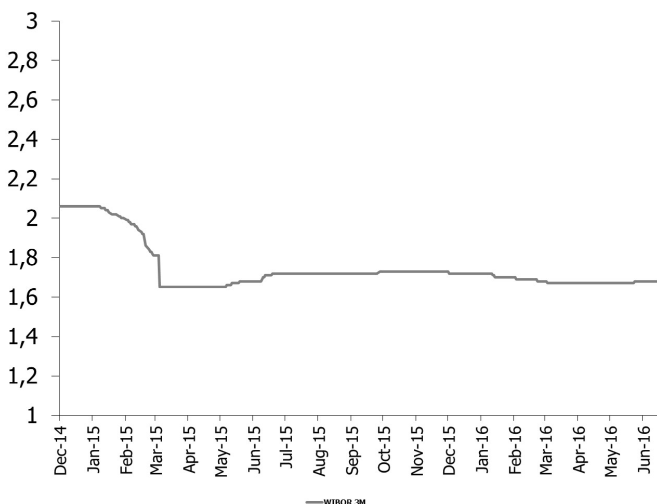
# Money market

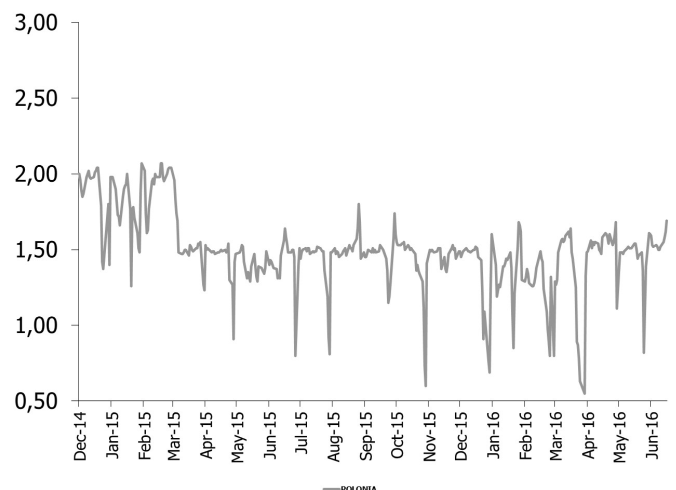
## Liquidity issues

We had a kind of apogee of fear on the market recently. Bonds hit new bottom, we had a squeeze on the cash market and even WIBORs started to rise. Our feeling is that the introduction of banking tax is to blame for the recent cash shortage. Polish market is characterized by over-liquidity at around 70 bn PLN held in NBP bills. After the introduction of new levy it was quite natural for banks to replace some of NBP bills with tax free short government bonds. In the first quarter banks bought 30 bn of government bonds, driven by tax optimization. Few months later we see that this process could be done by market participants and after some reshuffle in corporate/investment deposits some banks are short cash/long bonds. It might take some time for banks to rebuild cash cushion. However, a switch auction could be a remedy as short bonds will be sucked from the market.



# Forex

**Spot – Brexit fear** The was almost one-way traffic this week with as long PLN holders were rushing to the exit. EUR/PLN moved from 4.3650 (week's low) to 4.4570 (week's high). The liquidation of freshly installed post NFP PLN longs was adding fuel to this move. It is the fear of Brexit that is to blame for Zloty losses, as the international community is using PLN as a proxy for GBP. We assume that wide 4.39-4.49 range should hold, till the referendum results will be announced. We are neutral/tactical and ready to fade extremes to either side of the range. The Polish factor is at the sidelines for the moment.

**EUR/PLN vol even higher** The spike from last week, was only a prelude to vicious Vol buying during this week. If the result will be "leave", it seems that the sky is the limit. 1 month EUR/PLN ATM mid is this Friday at 10.7% (2.2% higher), 3 month EUR/PLN is 9.1% (1% higher) and finally 1 year is 9.0% (0.5% higher). The 1 week EUR/PLN reached 18% and 1 week USD/PLN touched 25%. Vols not only have moved right but are actually traded with 1 month being paid 10.50% and 10.70% and 10.90%. Backend was also in demand with trades in 9 months, 1 year and 2 years all at 9.00%. The Skew, especially in the frontend, was also extremely in demand. The currency spread (difference between USD/PLN vols and EUR/PLN vols) reached 6% for a 1 month!

## Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.31 / 4.44
USD/PLN: 3.70 / 4.00

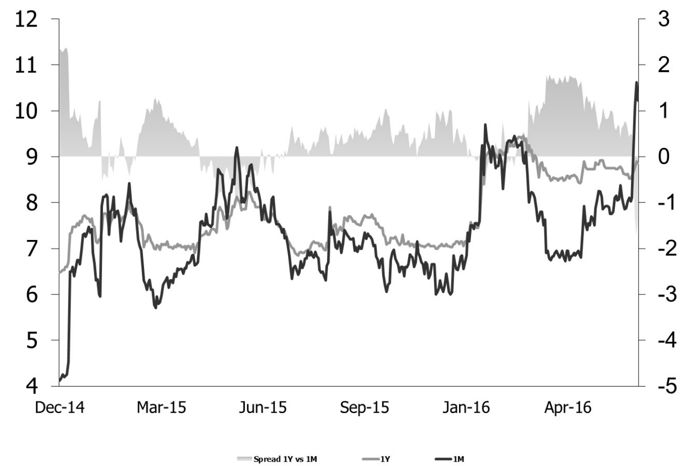
**Spot** Longs EUR/PLN from 4.3235 cashed at 4.4300.

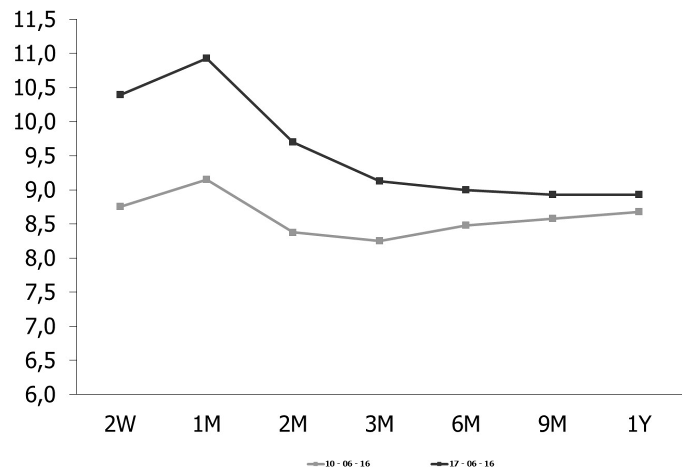
New position: None.

We would like to play inside 4.39-4.49 range till referendum date, with fading extremes being the most advisable approach. The liquidity is poor at best, so the position size should also be adequate to stormy days. Brexit itself is a binary outcome, prefect for adrenaline lovers. We are planning to go flat into referendum night. And join the side of the winners the next morning. We are aware it will be already a few good figures away, but both events (remain and leave) are strong enough to dominate markets for at least several sessions.

**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 cling to it. The reasons are simple: high bid/offer spread. Illiquid nature of EUR/PLN vols market is not at all in favour of active position adjustments. We still see enough reasons mostly from local politics but also from the Fed. Market structure (increased algorithmic presence) 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 |
| 6/9/2016 | 1.86 | 1.68 | 1.90 | 1.65 | 1.78 | 1.67 | 1.69 | 1.69 | 1.65 | 1.63 | 1.63 | 1.70 |
| 6/13/2016 | 1.75 | 1.68 | 1.95 | 1.65 | 1.84 | 1.67 | 1.70 | 1.69 | 1.67 | 1.66 | 1.66 | 1.73 |
| 6/14/2016 | 1.92 | 1.68 | 1.70 | 1.65 | 1.70 | 1.67 | 1.70 | 1.70 | 1.69 | 1.68 | 1.69 | 1.74 |
| 6/15/2016 | 1.71 | 1.68 | 1.77 | 1.65 | 1.78 | 1.67 | 1.71 | 1.69 | 1.68 | 1.67 | 1.69 | 1.73 |
| 6/16/2016 | 2.02 | 1.69 | 2.03 | 1.66 | 1.87 | 1.68 | 1.71 | 1.70 | 1.68 | 1.67 | 1.67 | 1.74 |

| 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 |
| 6/9/2016 | 1.670 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 6/13/2016 | 1.670 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 6/14/2016 | 1.670 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 6/15/2016 | 1.670 | 1.474 | 1.635 | 1.638 | 1.990 | 2.290 | 2.447 | 2.985 |
| 6/16/2016 | 1.680 | 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 |
| 6/9/2016 | 8.10 | 8.03 | 8.33 | 8.58 | 8.58 | 2.34 | 0.63 |
| 6/13/2016 | 10.10 | 8.58 | 8.60 | 8.78 | 8.78 | 2.34 | 0.63 |
| 6/14/2016 | 10.63 | 8.98 | 8.88 | 8.90 | 8.90 | 2.36 | 0.63 |
| 6/15/2016 | 10.23 | 8.88 | 8.83 | 8.85 | 8.85 | 2.37 | 0.63 |
| 6/16/2016 | 10.93 | 9.13 | 9.00 | 8.93 | 8.93 | 2.36 | 0.67 |

| PLN Spot performance | | | | | | |
|---|---|---|---|---|---|---|
| Date | EURPLN | USDPLN | CHFPLN | JPYPLN | HUFPLN | CZKPLN |
| 6/9/2016 | 4.3334 | 3.8126 | 3.9703 | 3.5803 | 1.3902 | 0.1604 |
| 6/13/2016 | 4.3900 | 3.8943 | 4.0360 | 3.6746 | 1.4055 | 0.1624 |
| 6/14/2016 | 4.4363 | 3.9483 | 4.0920 | 3.7328 | 1.4135 | 0.1640 |
| 6/15/2016 | 4.4155 | 3.9351 | 4.0750 | 3.7018 | 1.4070 | 0.1631 |
| 6/16/2016 | 4.4445 | 3.9469 | 4.1058 | 3.7888 | 1.4114 | 0.1642 |

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