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Polish Weekly Review

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Comment on the upcoming data and forecasts

Turn of the month brings as usually *flash* CPI as well as manufacturing PMI. When it comes to the first release, our final forecast still needs to be tailored. PMI will be published on Friday, so it is too early to give an exact number. However, review of CSOs' economic indices suggest slight growth there.

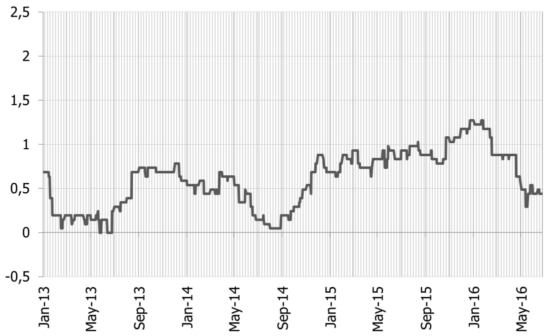
Polish data to watch: June 27th to July 1st

Publication	Date	Period	mBank	Consensus	Prior
CPI inflation y/y (%) *flash*	30.06	Jun		-0.9	-0.9
Inflation expectations (%)	30.06	Jun	0.2	0.2	0.2
Manufacturing PMI (p.)	01.07	Jun			52.1

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

Final release of unemployment rate came in line with market consensus (however lower than preliminary MLSP estimates), so Polish surprise index remained unchanged. Next week brings two opportunities to move the index – CPI inflation on Thursday and manufacturing PMI on Friday. Plenty of room for surprises there.

* 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

- Brexit...but life goes on. We stay constructive on 10Y Polish bonds.
- Markets are functioning close to normal (there is liquidity, picing mechanism works just fine – if it sputters, central banks have already gained expertise how to deal with such disturbances). Shock and awe has to fade away soon...
- ... and then we will switch to trading medium-term consequences with cold blood: lower growth and inflation, possibly more uncertainty amid even lower interest rates at global level. More easy monetary policy has to be expected as well.
- EU tensions affect Polish economy via traditional channels (trade, uncertainty, credit spreads). However, even harsh negotiations with GB are unlikely to alter 2014-2020 EU budget perspective. In such circumstances Polish growth model (mind 500+ programme) seems safe. Of course fiscal risks may arise as a side-product. We think, however, that it may be too soon to bet on them as a driver for Polish assets, including bonds.
- Zloty is subject to depreciation pressure mid-term. The more so since CHFPLN movement may potentially encourage policy makers to deal with CHF mortgages faster and in a more decisive way. That fuels uncertainty.

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

And yet Brexit

We were wrong about our "Bremain" call – on Thursday the Brits voted to leave the European Union. It seems that changes in European societies are for real – most elections in recent year ended with a surprise or very close to it. More Europeans do not want to settle for status quo and are willing to take the risk of trying something new.

From an economic point of view, Brexit is a true leap into unknown. Reshuffle of political elites and changes in the government are certain. Pound has already weaken significantly recording minima especially against safe haven currencies. Great Britain has, however, years for renegotiating trade agreements and re-establishing relations with the EU. Great Britains' present EU liabilities pose also a risk since the procedures concerning them are unclear.

We are not able to asses long-term consequences of Brexit for Europe – in fact nobody is. There are, however, a few scenarios worth mentioning – from the collapse of the whole block to cementing current core around euro zone with fiscal integration and a launch of fiscal package (this could be a remedy for Europe).

Estimates about impact on Polish growth, which could subtract ca 0.2pp (stated by NBP as well as by some market analysts) should not be taken seriously. The scope of uncertainty is too large to make point forecasts. There are scenarios in which Poland will be the source of further questioning of the current EU architecture. Instantaneous market response will be (already is) negative. For EMEA region it means less generous EU budget, which is especially dangerous for growth models based on co-financing and translates into widening current accounts. This may bring higher bond yields and weaker currencies at an almost crisis scale. Market participants will most probably be expecting NBP intervention.

Combination of lower interest rates in Europe and higher yields in Poland causes a dilemma. Polish bonds will be relatively attractive, because of the widening of spreads to other instruments. We wonder when market participant will move from responding to crisis moves to discounting medium term scenario of weaker growth and lower rates. We believe the latter is going to take the upperhand fairly soon.

What bothers us most

After the Brexit vote it is fairly easy to get preoccupied with nonsense calculations concerning the static trade effects and come up with numbers that are just numbers with no significance and meaning (as we said in the previous piece printed above). What bothers us is clearly multi-dimensional and has to be viewed rather as a set of risks. Our main concerns are enclosed in the following questions concerning the Polish economy.

1. Is it really only negative growth? Is it the true magnitude (NBP sources: 0.2-0.3%)? Of course trade channel, volatility, higher credit spreads and avalanche in the stock exchange are unambiguously negative. What if Brexit cements the core in euro zone and makes it easier to launch fiscal packages and more monetary stimulation? What struck us is the fact that the zloty depreciates only lightly. In case of any real shock, the lack of nominal adjustment only exacerbates the real effects.
2. What happens to UE funds in this one and another EU budgets? Is the current budget cast in stone? What if EU plays hardball with GB and there is a reciprocity, especially as the current government is done and will be replaced by eurosceptics? How can EU be able to decide or rule of anything common when some other members may threaten to leave?
3. What happens to Polish investment programme when it is based primarily on EU funds and Juncker's Plan. What happens to private investment? Firms already struggle to retain market share amidst fierce competition and deflationary pressure.
4. Are Poles going to return home? Some of them will be probably forced to do so. The new flow of migrants (out of PL) will be probably thinner. How about Turkey and refugee camps? Erdogan knows that more closed and fragmented EU means leaving Turkey outside EU. Why should they cooperate then with in case of migrants and refugees? Will they be still paid to keep them out of EU borders? In such circumstances we can easily see higher labor supply (returns from GB, possible bankruptcies) and some hit for current account (private transfers and remittances). One may await more arguments over refugees in coming months at EU-wide level.
5. What is going to happen with fiscal policy? Low inflation, possible downgrade, lower growth = higher deficit. Is it not connected with further hype towards seizing OFE assets? Is Morawiecki Plan (even as rudimentary sketched as it is now) going to be corrected or will it jump-start later?
6. On Polish rates. Is a combination of not-so-weak zloty, growth and deflation risks and another round of expansive monetary policy abroad enough to trigger rate cut in Poland? Or is it rather so gloomy for the condition of co-operative banks and savings and loans that current MPC stance (worries on financial stability) will prevail?
7. Last but not least: CHF mortgage bill. Will policy makers resist the temptations to rule and regulate at worst possible moment?

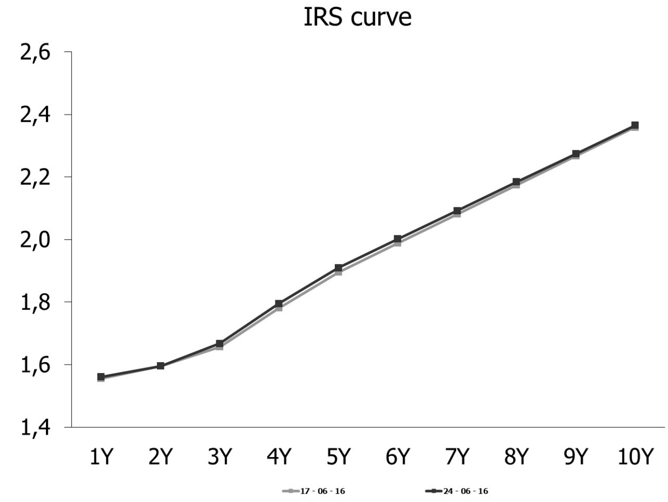
Fixed income

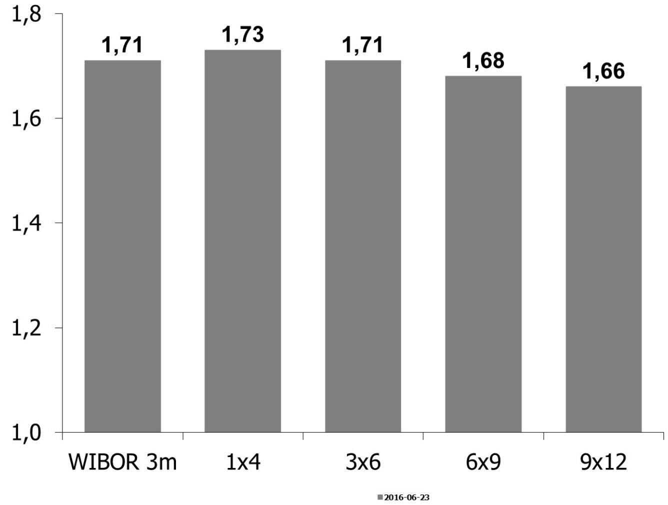
Big surprise?

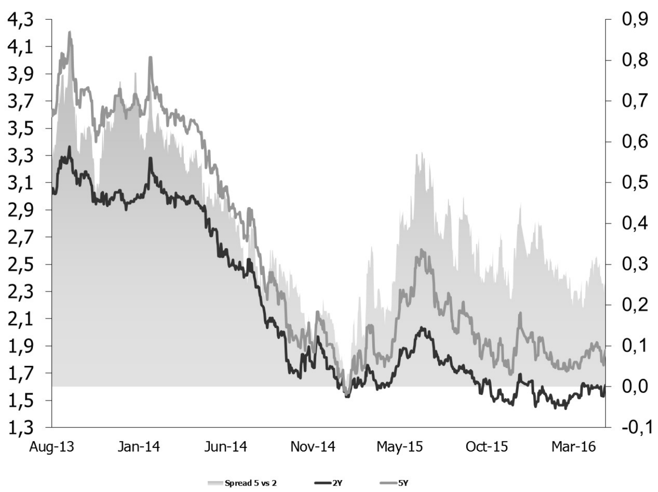
No significant reaction for Brexit seems to be the biggest surprise on domestic FI market. Both bonds and swaps opened respectively 20 and 12 bps higher so .... no big drama. The market was quite liquid on the 5y swap and 10y government benchmark. ASW widened a bit, mostly on the 10Y to 72 bps from 64 yesterday morning. Interesting thing is that now we are around 6 bps lower than we were last week discounting just some probability of Brexit.

In our opinion today's market move was quite insignificant, probably due to lack of positioning before referendum. Traders wanted to be square as probability of quit/leave scenario fluctuated around 50/50 for the last couple of days. It is now really hard to say what is likely to happen. On the one hand, we could exclude any harsh reactions of Central Banks for now (interventions on FX or interest rates). On the other hand UK exit might change political situation in whole Europe and lead to further market instability.

Current levels are 2y 1.75/1.78 5y 2.09/2.12 10y 2.51/2.54.





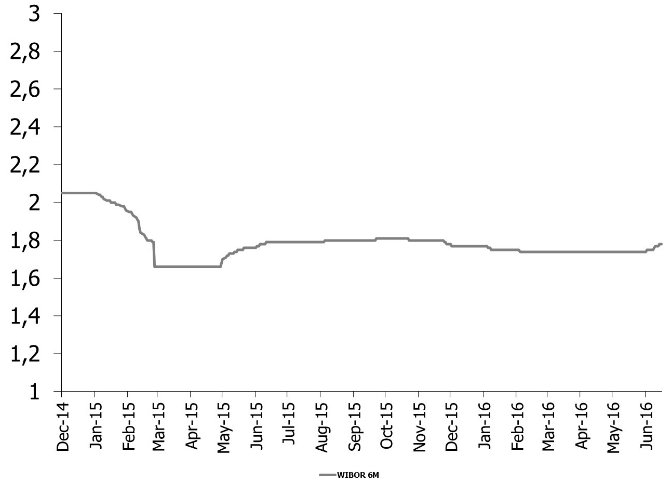


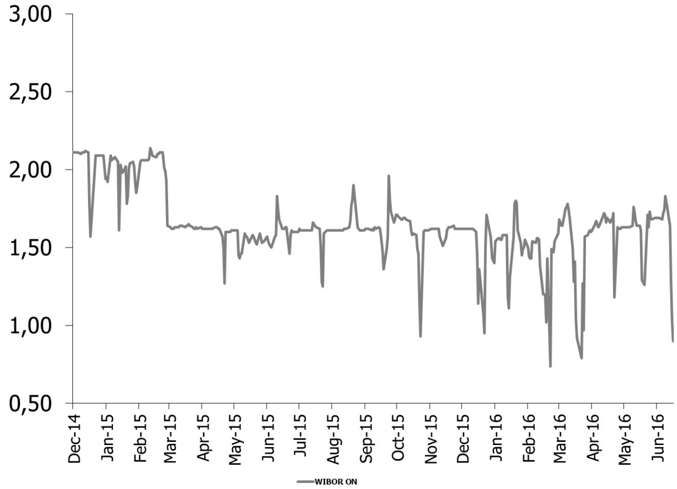
Money market

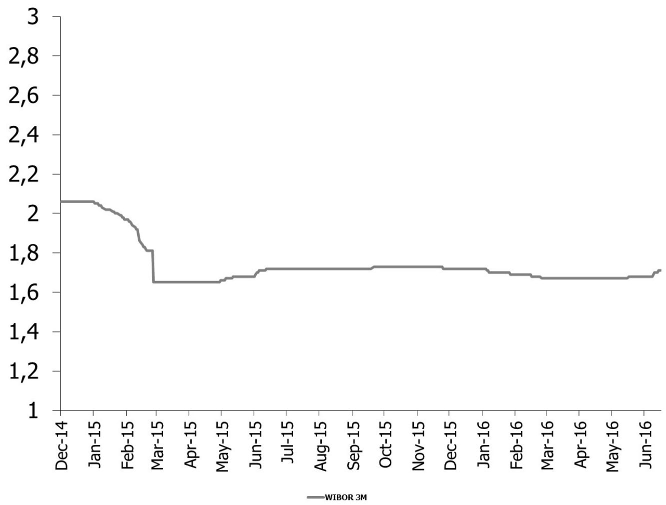
Brexit

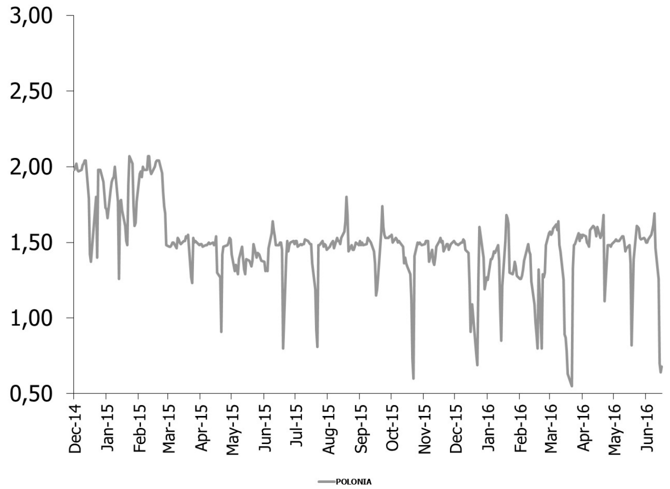
The Britons decided to leave EU. This unprecedented action took its toll on Polish assets with bond yields rising from 5bp on 1y to 25 bp on 10y govies. Market participants were quite well prepared for any turbulences and left 10 bio liquidity buffer on last NBP auction. Thanks to this approach we had a relief in overnight funding with cash trading close to deposit rate. We welcome such stance from banks and wish NBP would also support excessive liquidity for next few weeks to ease concerns about Polish assets, at least the shortest ones.

Ref rate vs Polonia averages:
30 day 12 bp
90 day 7 bp





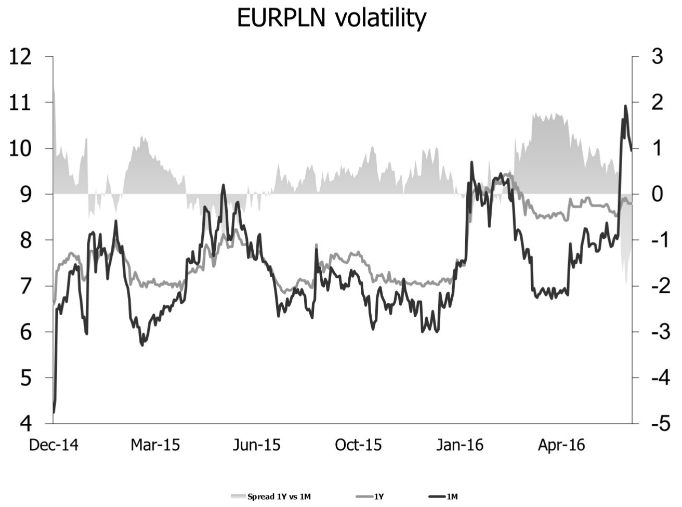




Forex

Spot – Brexit is a fact On Thursday EURPLN was sliding from 4.44 to 4.34 (the low was recorded on ”Brexit night”) and the world looked thirsty for risk. The next morning we hit 4.5400 high, before it corrected to 4.45 on mostly local supply of hard currencies. Well . . . , it is a new world now. Buy EUR and sell PLN is a bit of knee jerk reaction, if one thinks more deeply about that. Buying USD/PLN, JPY/PLN, CHF/PLN is much more cleaner way of expressing risk off approach. Speaking of the devil, higher CHF/PLN may revoke fresh pressure on potential CHF conversion project. That's the biggest possible threat we see for the zloty. A sword of Damocles is upon us.

EUR/PLN vol exploded Quote from last week *The spike from last week was only a prelude to vicious Vol buying during this week. If the result is ”leave”, the sky is the limit*. 1 month EUR/PLN ATM mid is this Friday at 13% (2.7% higher), 3 months EUR/PLN are 10.75% (1.65% higher) and finally 1 year is 10.0% (1% higher). Skew and currency spread (difference between USD/PLN and EUR/PLN vol) are all higher, hard to say by how much. The curve is inverted and we are in pure crisis mode. We are afraid of the market stop losses as VAR evaluations will all signal red.



Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.40 / 4.60
USD/PLN: 3.80 / 4.20

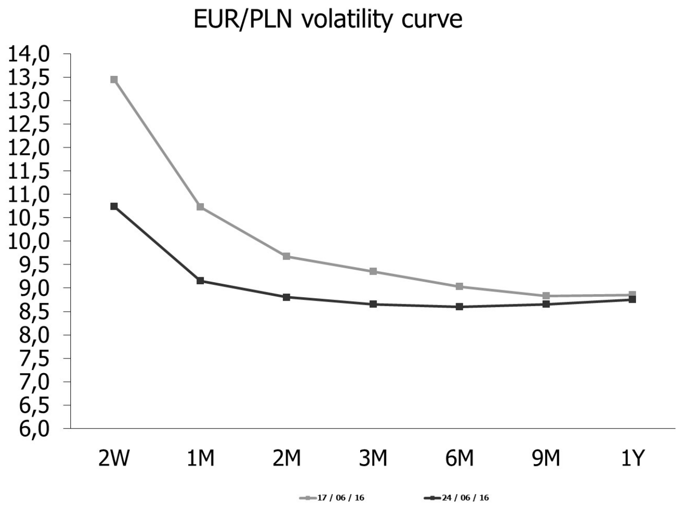
Spot

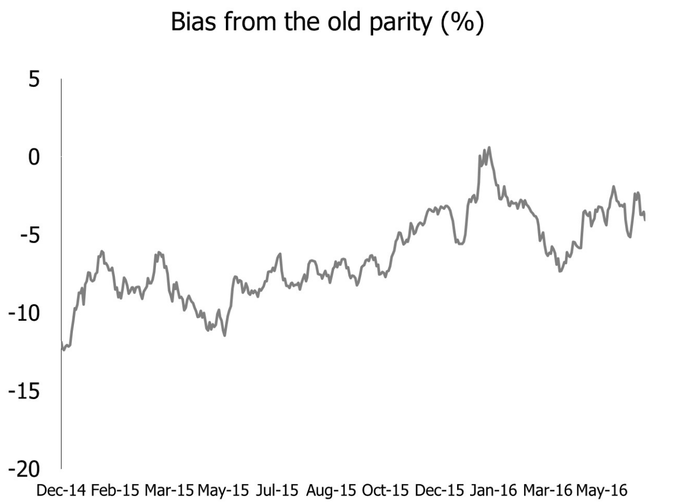
New position: None.

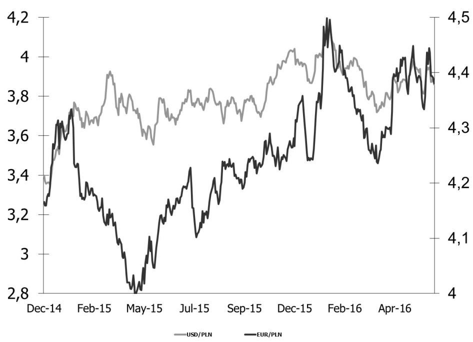
The dust have to settle first. Till then we are adopting tactical, short-term approach with no strategic position/view in place. We would try to play long EUR/PLN against 4.42/4.40 support zone. Our desire to fade spikes is limited unless we see 4.57/4.60 resistance. With liquidity being really poor, one may expect whippy price actions.

Options Vols – Long Vega in the backend

We have taken long in backend Vega, fearing a situation as such may happen. We were more afraid of local Polish factor then Brexit, but it is the latter that has materialized. We are of the view that it will not be solved overnight. Most likely we will see the vols even higher before some calm will come back to the market. We are keeping the position.







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
6/16/2016	2.02	1.69	2.03	1.66	1.87	1.68	1.71	1.70	1.68	1.67	1.67	1.74
6/20/2016	1.74	1.70	1.68	1.67	1.70	1.70	1.71	1.69	1.66	1.63	1.61	1.70
6/21/2016	1.95	1.71	1.86	1.68	1.88	1.70	1.73	1.72	1.69	1.66	1.65	1.76
6/22/2016	1.72	1.71	1.77	1.68	1.80	1.70	1.73	1.72	1.69	1.67	1.67	1.74
6/23/2016	1.87	1.71	1.96	1.68	1.85	1.70	1.73	1.71	1.68	1.66	1.64	1.75

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
6/16/2016	1.680	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/20/2016	1.700	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/21/2016	1.700	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/22/2016	1.700	1.474	1.635	1.638	1.990	2.290	2.447	2.985
6/23/2016	1.700	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
6/16/2016	10.93	9.13	9.00	8.93	8.93	2.38	0.65
6/20/2016	10.28	9.00	8.78	8.80	8.80	2.38	0.65
6/21/2016	10.13	8.98	8.78	8.80	8.80	2.37	0.64
6/22/2016	9.95	8.95	8.75	8.80	8.80	2.37	0.66
6/23/2016	9.15	8.65	8.60	8.75	8.75	2.43	0.69

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/16/2016	4.4445	3.9469	4.1058	3.7888	1.4114	0.1642
6/20/2016	4.3945	3.8724	4.0355	3.7041	1.4066	0.1624
6/21/2016	4.3935	3.8741	4.0380	3.7101	1.4023	0.1623
6/22/2016	4.3900	3.8945	4.0597	3.7289	1.3948	0.1622
6/23/2016	4.3806	3.8593	4.0383	3.6917	1.3922	0.1618

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