July 1, 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

There is only one important economic publication next week, but the outcome is obvious – MPC will not change interest rates. This will happen despite economic growth slowdown (which is seen as temporary by MPC members as well as NBP researchers), prolonging deflation and increase of global risk – e.g. Brexit. MPC is now focused on supporting paradigm of stable, even constant interest rates. Brexit will be for sure mentioned in the information after the meeting and a focal point of the press conference after the meeting. However, because of slight estimated impact on Polish economy, it will be downplayed. MPC decision will be accompanied by publication of newest NBP projections with updated paths of GDP and inflation.

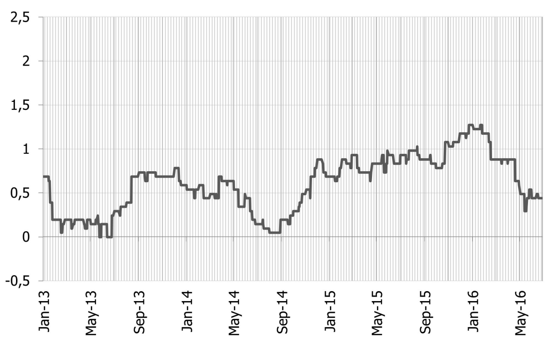
Polish data to watch: July 4th to July 8th

Publication	Date	Period	mBank	Consensus	Prior
MPC decision (%)	06.07	Jul	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	7/7/2016	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	7/7/2016	20	2.092	3/12/2015

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



Comment

Unchanged as neither the flash CPI, nor the PMI surprised in a significant way. Polish surprise index will stay flat next week as there are no data releases 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).

mBank.pl

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.
- Given the fact that the whole scope and timeline of Brexit repercussions is still unclear, it is high time to take profit on our recommendation. The more so since it is negative for credit risk among EMs and Polish assets are facing other, idiosyncratic risks (rating, CHF bill).
- We feel that foreign investors may be still reluctant to add Poland to their portfolios despite some recent outperformance.
- Zloty to be range bound. Headwinds due to upcomming event risks but fundamentally attractive levels.

mBank forecasts

	2010	2012	2013	2014	2015	2016 F
GDP y/y (%)	3.7	1.6	1.3	3.3	3.4	3.4
CPI Inflation y/y (average %)	2.8	3.7	0.9	-0.1	-0.9	-0.4
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

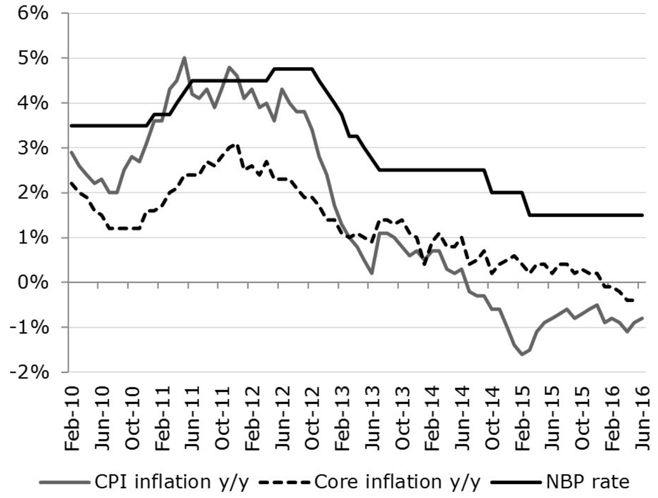
	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1 F	2016 Q2 F	2016 Q3 F	2016 Q4 F
GDP y/y (%)	3.6	3.1	3.4	4.3	3.0	3.3	3.4	3.5
Individual consumption y/y (%)	3.1	3.1	3.1	3.0	3.2	3.6	4.1	4.4
Public Consumption y/y (%)	1.8	0.8	0.9	8.7	4.4	4.0	4.0	4.0
Investment y/y (%)	11.8	5.8	4.4	4.4	-1.8	0.5	2.0	3.5
Inflation rate (% average)	-1.4	-0.9	-0.7	-0.6	-0.9	-0.9	-0.5	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	1.71	1.71	1.44
2Y Polish bond yields (% eop)	1.61	1.99	1.76	1.62	1.45	1.65	1.50	1.40
10Y Polish bond yields (% eop)	2.31	3.31	2.84	2.94	2.84	2.91	3.15	3.05
EUR/PLN (eop)	4.07	4.19	4.25	4.26	4.24	4.38	4.35	4.30
USD/PLN (eop)	3.80	3.76	3.80	3.92	3.73	3.94	3.99	3.98

F - forecast

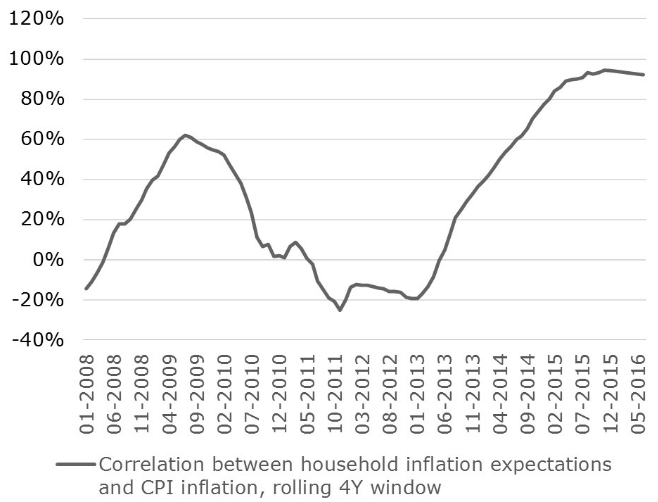
Economics

Second anniversary of deflation in Poland. Will Poland turn into another Japan?

According to the flash estimate, inflation rose slightly in June to -0.8% from -0.9% y/y in May, basically in line with market consensus (between -0.8% and -0.9%, depending on the source).



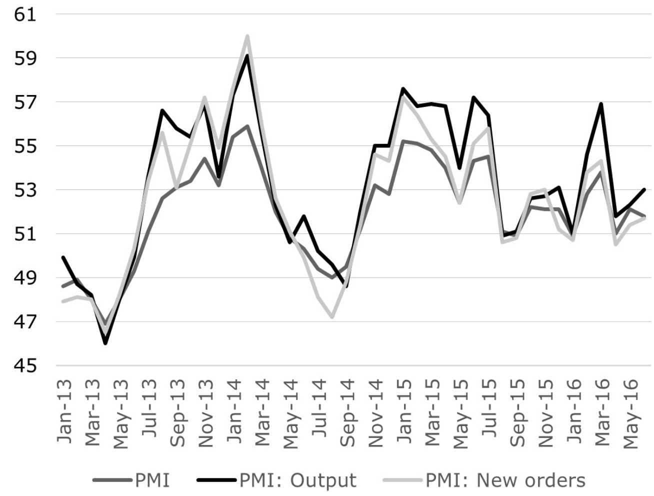
Our estimates indicated a stabilization in food prices and 2% growth of fuel prices on a monthly basis. Core inflation most likely held steady at -0.4% y/y. Deflationary processes still rule, however, question asked by us in the title is just a joke. We are celebrating the second anniversary of deflation, which wasn't supposed to occur in the first place. Furthermore, contrary to what some economists, is not only a statistical effect. In addition to fuel prices, it is driven by pass – through of the declines in commodity prices but also a lagged effect low inflation expectations. One should take note of the latter – it shouldn't come as a surprise that household inflation expectations have become highly correlated with actual inflation in recent years (a clear case of deanchoring – see chart below). In addition, companies still are not able to rise prices because of macroeconomic environment (structural lack of demand in Europe).



We will see positive inflation only in the last quarter of 2016 and only because of base effects. The data do not change monetary policy perspectives in the near term. MPC still points to systemic risks stemming from low interest rates (cooperative banking sector). In the next quarters Poland and Europe will remain in an environment of deflation and relatively low economic growth. Brexit brings nothing new here. Hence, we still see risk of interest rate cuts in Poland (now we are standing out in the low yielders group).

A slight decline in the PMI

In June Poland Manufacturing PMI slightly declined from 52.1 to 51.8, contrary to market consensus (52.6) and above our too pessimistic forecast (51.2). The details of the release are rather interesting this time, since the PMI declined despite the fact that both output and new orders increased (from 52.3 to 53.0 and from 51.4 to 51.7, respectively), while employment stabilized. The reason for this is that delivery times lengthened, reversing the decline from the previous month – there's really no story here.



While the key subindices of the PMI improved a bit in June, current levels are rather modest. Furthermore, recent changes are too small to have a meaningful impact on hard data. In turn, currently modest levels of the PMI imply that economic growth has not accelerated materially in the second quarters. Given this and how real sphere indicators evolved in the last three months, it is obvious that GDP growth forecasts should drift down to ca. 3.2-3.3% y/y. In addition, if we add the fact that export orders are growing at a faster pace than the domestic ones, it is also clear that domestic demand hasn't accelerated either, which suggests that the slowdown in public investment and associated industries extended itself to the second quarter (as already seen in dismal construction output figures). Last but not least, our skepticism regarding inflationary processes in industry was proved correct as factory gate prices declined in June.

The broader picture of the Polish economy is unchanged – it managed to slow down a bit even before inflation returned. This should put pressure on the central bank to cut rates, especially in current high-risk, low-rate, low-growth environment (the new round of monetary easing on core markets is also an argument for it). For this reason we stick to our forecast of rate cuts this year.

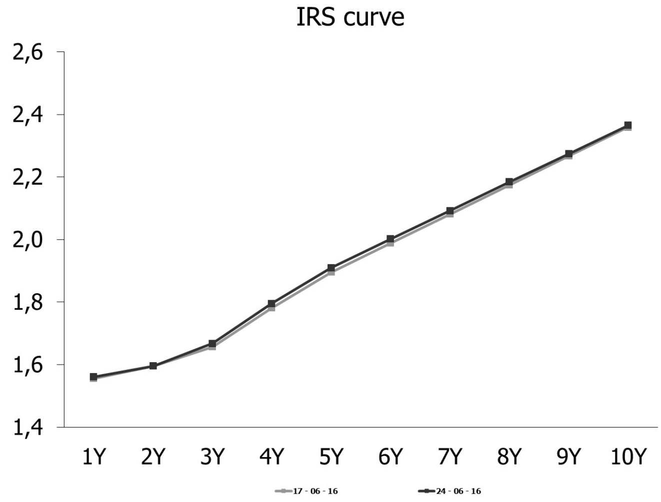
Fixed income

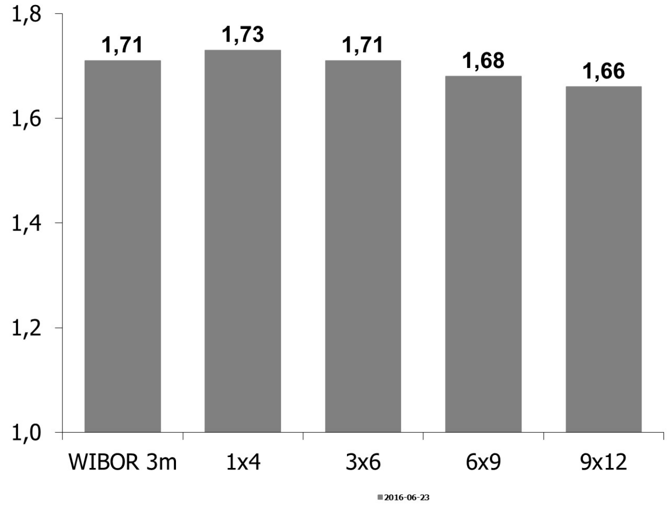
Is there any bottom?

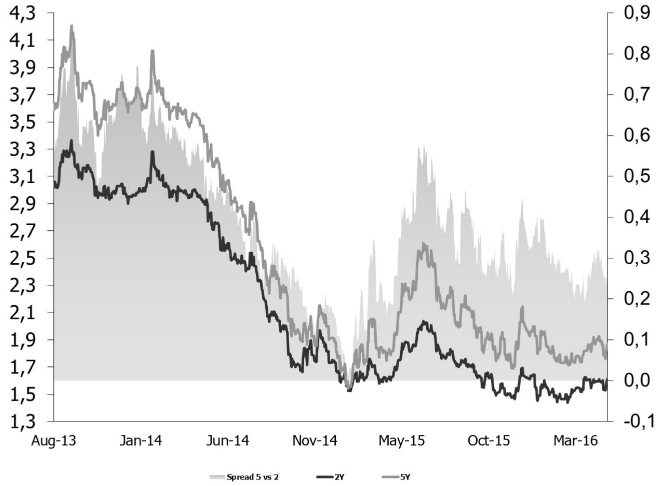
Post Brexit speculations about additional QE in EU pushed European yields to historical lows and Polish market followed that move. We are now still far away from historical lows on bonds but much closer on swaps. Another reason for such a huge bullish was lack of 5y govies auction (while market was short in this sector).

We follow our economists forecast and do not suggest to buy Polish long term bonds. Whole move on rates is just based on rumors about potential ECB actions and huge slowdown in EU but currently we can't see any figures confirming it. Also, we don't really believe in some speculations about impact on Polish economy like the one about return of Polish workers from UK, which would flood our job market with lower salary expectations.

We can suggest buying 2Y swaps at 1,56 (23 bps under current WIBOR and more than 25 bps rate cut priced in) or 1Y1Y vs 9x12 spread at -1. We like buying 2v10y at 55, but this time with a small stop loss.







mBank.pl

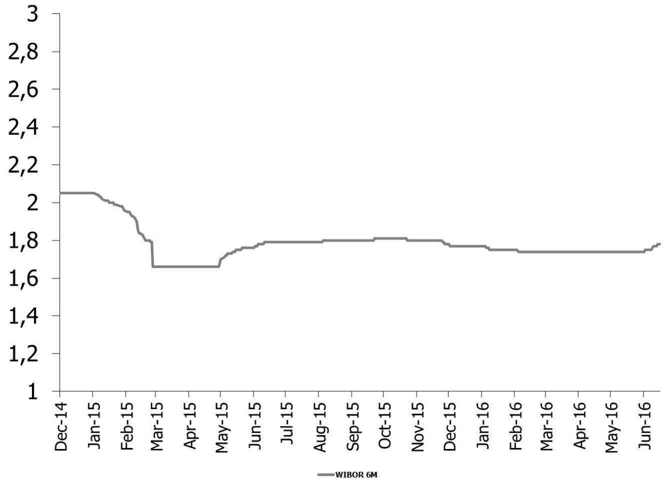
Money market

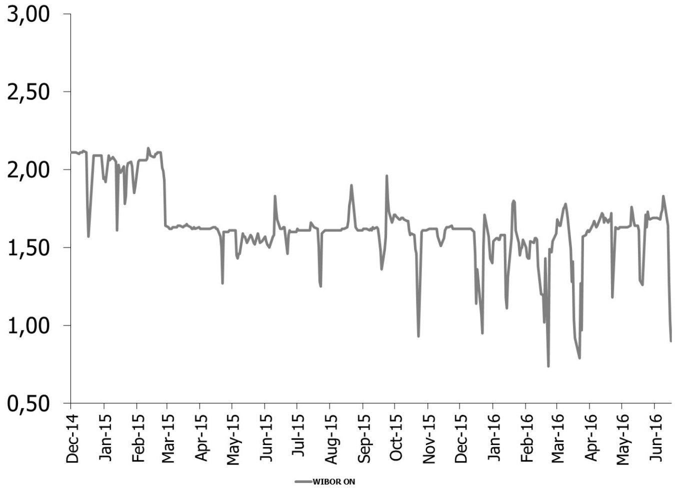
Rate cuts vol. 2

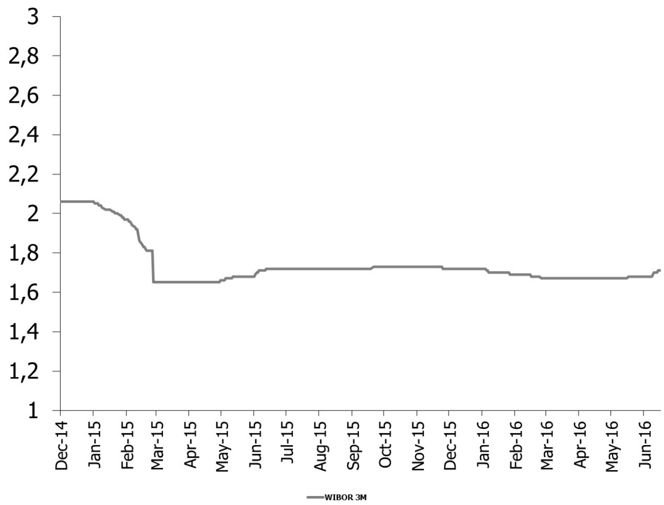
Money market players went through the Brexit turmoil well. With 10 bn spare liquidity left on the market, Polonia held around 1.20% level and easy funding was secured for everyone. Banks are still in a safe mode, buing only 57.2 bn NBP bills out of 61.5 offered. To sum up, we shouldn't observe any cash squeeze for next few weeks, but we wouldn't expect any extreme cheapness, as the central bank can step in with fine tuning operations.

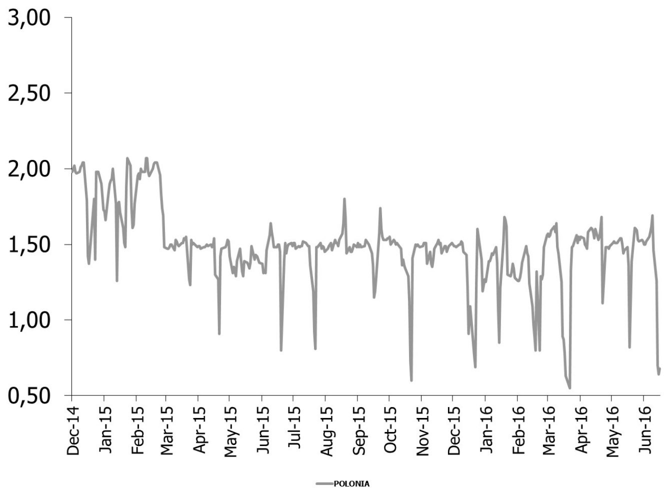
One week after Brexit one could argue that the market couldn't expect any better outcome of the vote. Bonds ralied heavily all over the world on core and emerging markets pushing yelds to new lows in many countries. In Poland front end derivatives started pricing in 25+ bp cut again. We think that short bonds are lagging the move and would look at buing OK0717 vs 1Y OIS ASW at 25bp (1,60% and 1,35%).

Ref rate vs Polonia averages:
30 day 15 bp
90 day 7 bp





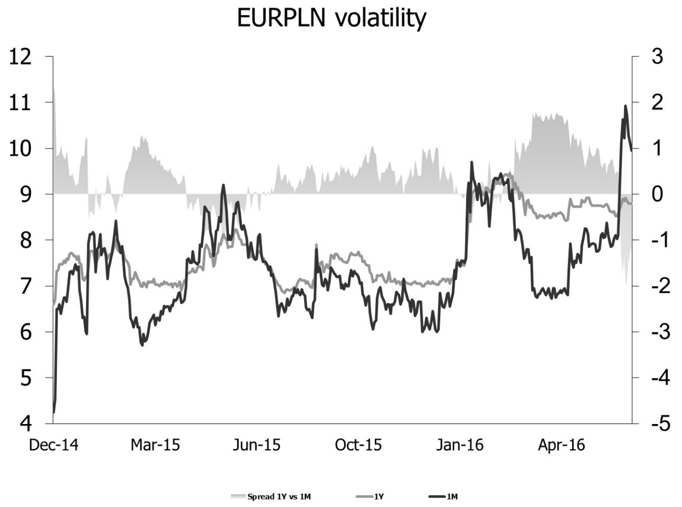




Forex

Spot – Brexit, what Brexit? It is really funny, only a few days after the Brexit referendum, it is hard to find any sign of stress in PLN exchange rate or vols. Seems Brexit is no longer a threat, Central Banks' dovish remarks are fueling fresh CEE buying spree. As a result EUR/PLN has dropped like a stone, from 4.54 post Brexit high to last Thursday's 4.3675 low. What happened, is for sure negative for Poland, but the fundamental effects simply needs time to kick in. Prudent approach is to assume that EUR/PLN trading range has simply shifted higher i.e. 4.35-4.55. We have rating agencies meetings in front of us, same caution is recommended.

EUR/PLN vol exploded and collapsed Today, 1 month EUR/PLN ATM mid is this Friday at 8.8% (4.2% lower!!!), 3 month EUR/PLN is at 9.00% (1.75% lower) and, finally, 1 year is 9.1% (0.9% lower). The skew and currency spread (difference between USD/PLN vol and EUR/PLN) are both lower, back to pre-referendum levels. The curve regained its usual steepness, crisis is called off.



Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.35 / 4.55
USD/PLN: 3.80 / 4.20

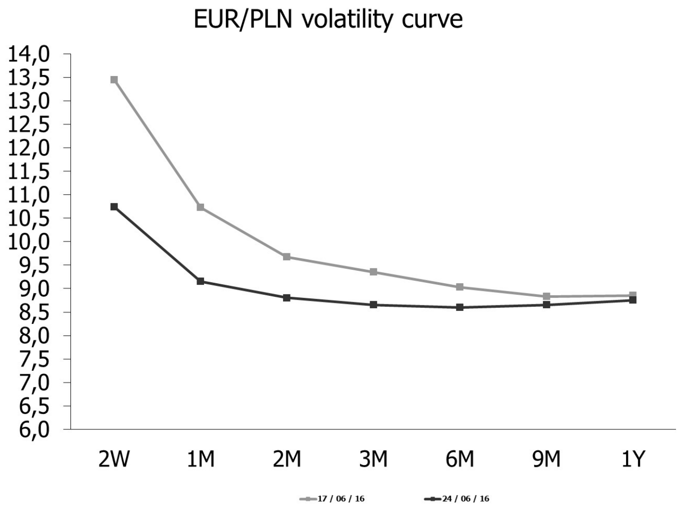
Spot

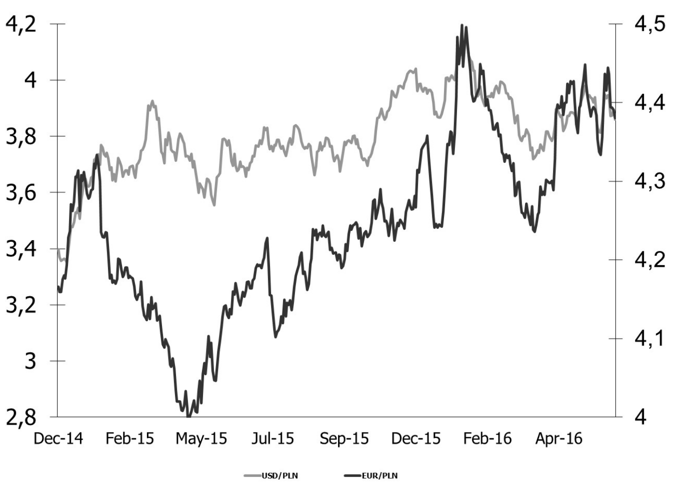
New position: We are long EUR/PLN at 4.3770. We are ready to add at 4.3470 with a stop bellow 4.3220 and hopes to see 4.45+.

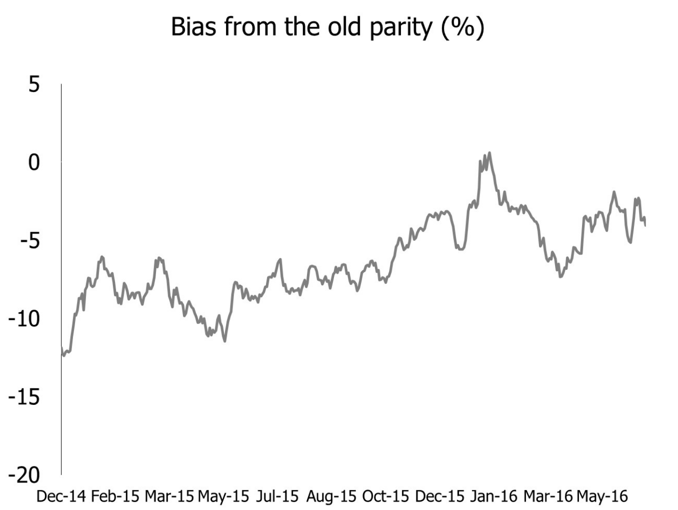
The dust has settled. We are skeptical that usual central bank dovish pill will keep on working forever. For choice, we are tactically skewed to buy dips. We still see political risk in Poland and the possibility of rate cuts is again looming on the horizon.

Options Vols – Long Vega in the backend

We are still long Vega in the backend of EUR/PLN vols. The vols spike was really short lived, and the vols melted as a result. It is frustrating, but we think that our view has received a fundamental backup. There is a lot of uncertainty surrounding the Brexit which will have to take its toll on Poland as well. We stick to our position.







mBank.pl

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
6/23/2016	1.87	1.71	1.96	1.68	1.85	1.70	1.73	1.71	1.68	1.66	1.64	1.75
6/27/2016	1.87	1.71	1.96	1.68	1.85	1.70	1.73	1.71	1.68	1.66	1.64	1.75
6/28/2016	1.87	1.71	1.96	1.68	1.85	1.70	1.73	1.71	1.68	1.66	1.64	1.75
6/29/2016	1.87	1.71	1.96	1.68	1.85	1.70	1.73	1.71	1.68	1.66	1.64	1.75
6/30/2016	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
6/23/2016	1.700	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/27/2016	1.700	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/28/2016	1.700	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/29/2016	1.700	1.474	1.635	1.638	1.990	2.290	2.447	2.985
6/30/2016	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
6/23/2016	9.15	8.65	8.60	8.75	8.75	2.43	0.69
6/27/2016	9.15	8.65	8.60	8.75	8.75	2.43	0.69
6/28/2016	9.15	8.65	8.60	8.75	8.75	2.43	0.69
6/29/2016	9.15	8.65	8.60	8.75	8.75	2.43	0.69
6/30/2016	9.15	8.65	8.60	8.75	8.75	2.43	0.69

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/23/2016	4.3806	3.8593	4.0383	3.6917	1.3922	0.1618
6/27/2016	0.0000	0.0000	4.0383	3.6917	1.3922	0.1618
6/28/2016	0.0000	0.0000	4.0383	3.6917	1.3922	0.1618
6/29/2016	0.0000	0.0000	4.0383	3.6917	1.3922	0.1618
6/30/2016	0.0000	0.0000	4.0383	3.6917	1.3922	0.1618

Disclaimer