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Polish Weekly Review

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Comment on the upcoming data and forecasts

Tuesday brings the releases of detailed Q2 GDP data. We expect it to confirm the flash reading of 3.1% y/y and to show a continued decline in investment (-1.0% y/y) amid acceleration in consumption (3.6% y/y). On the next day (no official confirmation yet) the CSO will release flash CPI data for August – lower fuel prices might bring annual inflation down again. The last highlight of the week is the Manufacturing PMI, due on Thursday. We expect a slight increase, consistent with mixed signals from CSO's indicators.

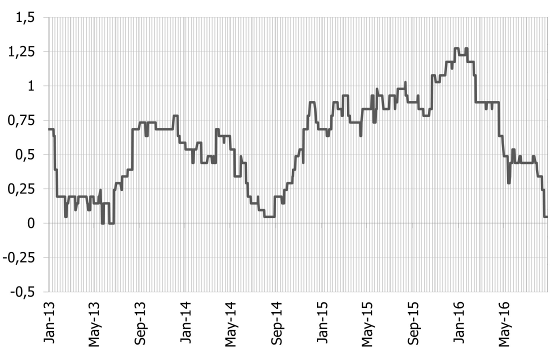
Polish data to watch: August 29th to September 2nd

Publication	Date	Period	mBank	Consensus	Prior
GDP y/y (%) *final*	30.08	Q2	3.1	3.1	3.0
CPI y/y (%) *flash*	31.08	Aug			-0.9
Manufacturing PMI (pt.)	01.09	Aug			50.3

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	-	2000	1.666	8/18/2016
5Y T-bond PS0721	-	3500	2.114	8/18/2016
10Y T-bond DS0726	-	2000	2.704	8/18/2016
15Y T-bond WS0428	-	200	3.027	7/7/2016

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



Comment

Unemployment rate came in line with preliminary MFLSP data, so Polish surprise index remained unchanged. Next week brings plenty of opportunity to change it with final GDP, *flash* CPI and manufacturing PMI.

* 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. Despite weak Zloty, exports growth ground into a halt. 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 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 and brisk wage growth), many years of moderate 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 is 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. We expect the MPC to finally acknowledge inflation risks amid temporary weakness in GDP growth and another round of monetary policy stimulation globally. Lower risk premia will certainly help.

Financial markets

- Zloty is set to perform well in the near term.
- The details of the CHF conversion are unlikely to be announced soon. Therefore globally easy central bank policy is going to propel all non-zero yielding assets.
- Owing to ultra easy path of Fed funds already priced in, we see the more hawkish Fed as the prevailing risk short-term. We do not expect any moves concerning the possible repricing of U.S. rates to be of such magnitude as the ones we saw at the start of the year. EMs are in a different cyclical position and enjoy higher interest rates.

mBank forecasts

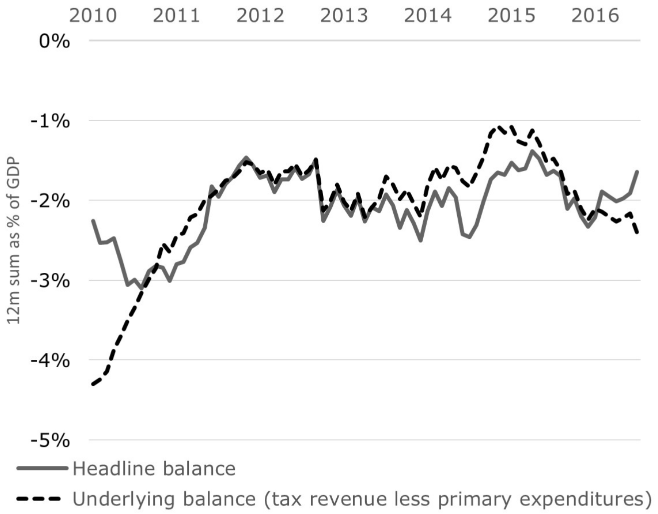
	2012	2013	2014	2015	2016 F	2017 F
GDP y/y (%)	1.6	1.3	3.3	3.4	3.2	3.5
CPI Inflation y/y (average %)	3.7	0.9	-0.1	-0.9	-0.4	1.7
Current account (%GDP)	-3.7	-1.3	-2.0	-0.1	-0.7	-0.9
Unemployment rate (end of period %)	13.4	13.4	11.4	9.8	8.7	8.1
Repo rate (end of period %)	4.25	2.50	2.00	1.50	1.25	1.25

	2016 Q1	2016 Q2 F	2016 Q3 F	2016 Q4 F	2017 Q1 F	2017 Q2 F	2017 Q3 F	2017 Q4 F
GDP y/y (%)	3.0	3.1	3.3	3.4	3.4	3.5	3.5	3.6
Individual consumption y/y (%)	3.2	3.6	4.1	4.4	4.5	4.3	4.0	3.6
Public Consumption y/y (%)	4.4	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Investment y/y (%)	-1.8	-2.0	0.5	2.4	4.0	5.5	6.0	7.0
Inflation rate (% average)	-0.9	-0.9	-0.5	0.6	1.3	1.5	1.5	1.6
Unemployment rate (% eop)	10.0	8.9	8.6	8.7	8.9	8.2	7.8	8.1
NBP repo rate (% eop)	1.50	1.50	1.50	1.25	1.25	1.25	1.25	1.25
Wibor 3M (% eop)	1.67	1.71	1.71	1.44	1.44	1.44	1.44	1.44
2Y Polish bond yields (% eop)	1.45	1.65	1.50	1.40	1.30	1.30	1.30	1.30
10Y Polish bond yields (% eop)	2.84	2.91	2.80	2.80	2.80	2.80	2.80	2.80
EUR/PLN (eop)	4.24	4.38	4.25	4.25	4.25	4.25	4.25	4.25
USD/PLN (eop)	3.73	3.94	3.90	3.94	3.97	4.05	4.05	4.05

F - forecast

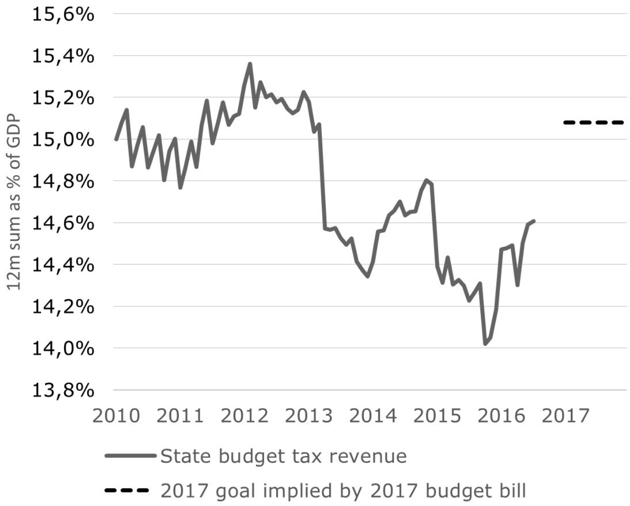
Fiscal update: the 2017 budget is ambitious, but feasible

According to latest monthly statement from the Ministry of Finance, state budget deficit narrowed to 14.4 bn PLN after July, making it a best 7-month period since 2008, regardless of metric used (nominal, % of GDP, % of FY target). This impressive result was, however, brought about by one-off non-tax revenues (LTE auction proceeds and NBP profit). Our measure of underlying fiscal balance (which excludes non-tax revenue and debt service costs) shows a deterioration, not an improvement. It should also be clear that the introduction of child subsidy programme implies a steeper path of state deficit in the second half of the year.

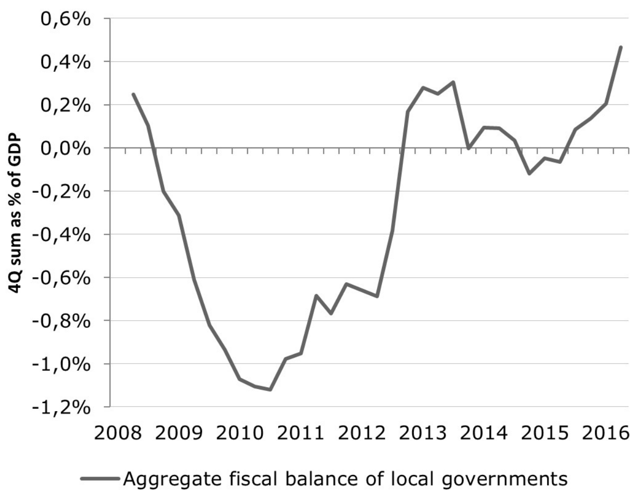


In light of this it is necessary to look at the underlying tax revenue trends and these are quite good. In July alone total tax revenue grew by 4.7% y/y, driven by strong PIT and VAT income growth. Judging from the year-to-date figures, we expect VAT, PIT and excise tax revenues to exceed the MoF's expectations by a total of 4.5 bn PLN. This slightly exceeds the shortfall from lower bank and retail taxes. With expenditure side quite subdued, one can reasonably expect the 2016 deficit to be at least 10-15 bn PLN lower than the bill stipulated (55 bn PLN).

The focus should be, however, on the 2017 budget – the first one prepared exclusively by the new government, the first one including the full cost of child subsidy programme and the first one meaningfully affected by various tax reforms introduced by the government. So far, we know that the deficit limit is planned at 59.3 bn PLN which is a result of an increase in revenues (from 314 to 324 bn PLN) and expenditures (from 368 to 383 bn PLN). The headline deficit is hyped by some as a „record high" deficit but this is economic illiteracy: nominal deficits should not be compared over decades (sic!); if off-budget loans to social security fund (FUS) are included, 2016 and 2017 figures are almost identical; it is the general government deficit that matters most anyway.



As mentioned above, the two big one-offs on the revenue side disappear in 2017, so tax revenue must make up for this and for increased expenditure. Can it? By our calculations, tax revenues must increase by 23 bn PLN in 2017 which amounts to an impressive +8.3% y/y. VAT revenues are projected to grow even faster, by 11% y/y (2016 ytd growth is, respectively, 6.5 and 6.7%). With bank, retail and mining taxes unchanged, this implies an increase in the effective tax rate from current levels to 15.2-15.3%. A priori it is ambitious but not impossible – after all, it would be a return to 2011-2012 tax/GDP ratios. It can be doubted whether such a big increase can be achieved within several months but planned and already introduced tax reforms cannot be discounted. In a realistic scenario, if current tax revenue growth is maintained throughout 2017, the MoF will fall short of its revenue target by 5-7 bn PLN. With some undershoot in expenditures (as always), the headline budget deficit is not in danger next year.



One cannot ignore the bigger picture, though. Next year's state budget is still on a knife edge and the required revenue growth can easily be dragged by lower growth. Secondly, the path of fiscal consolidation relies heavily on local governments and social security funds maintaining strict budgetary discipline. While the latter is not an issue due to rising labor share and private pension fund reforms, local governments are already running a substantial (record high in fact) surplus. It won't be maintained when EU funds start flowing again and general government deficit looks set to remain close to 3% in the coming years.

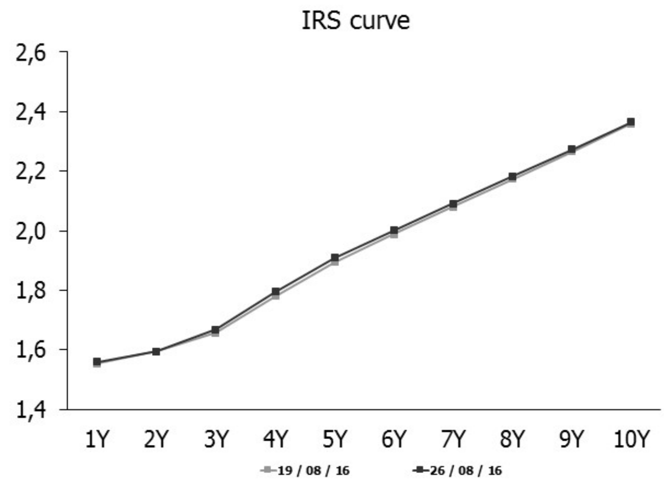
Fixed income

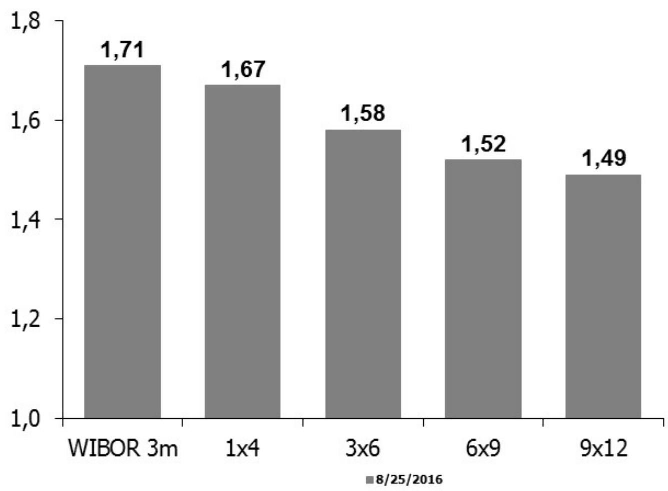
Waiting both globally and locally

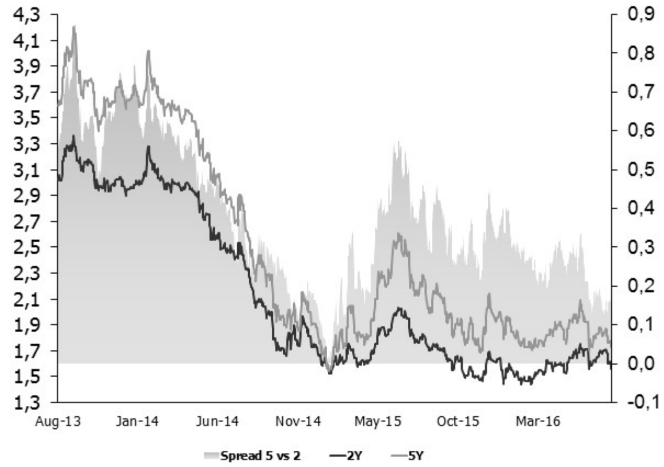
While market is waiting for Jackson Hole, everyone wants to be neutral. We don't expect that something spectacular will be told.

Next week we will have the first auction in September. We expect OK1018, DS0726 (maybe DS0727) and WZ0126. As no one wants to have a position for the weekend, local banks will be on the offer from Monday. If supply is in line with our view, we will see steepening of 5Y/10Y(current level is 58bps).

ASWs remain expensive, 5y PS0721 34/32 and 10y DS0726 55/53. At the end of month 2.6bio of TB310816 expires and, because of tax reasons, this free cash has to be spend. We still like medium and short end bonds.







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Money market

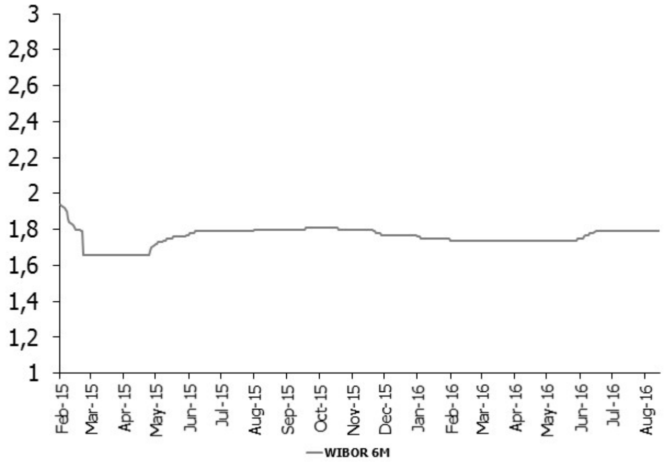
Stable range before end of month

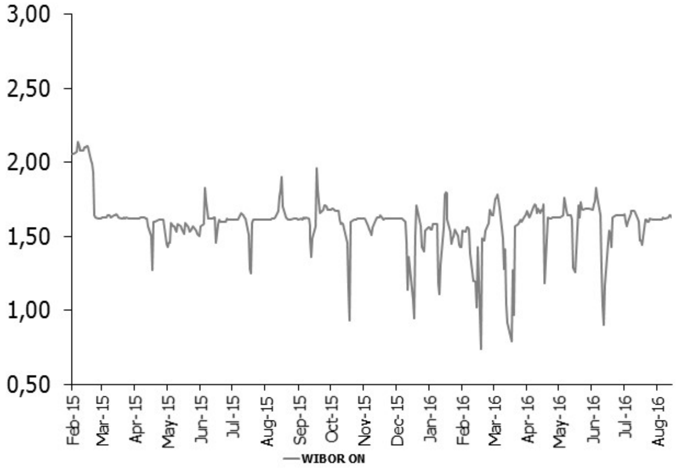
Shortest rates found a support around 25bp cut priced and are gradually grinding higher following hawkish comments from MPC members.

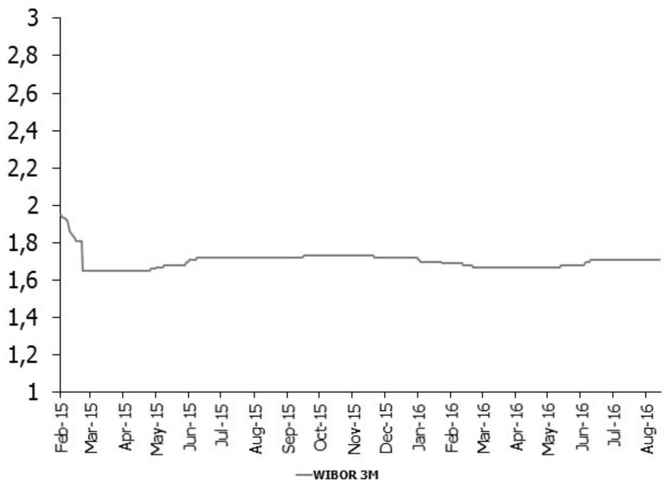
Market awaits comments from conference in Jackson Hole in a stable range, also next week's flash CPI print may bring some life into the market.

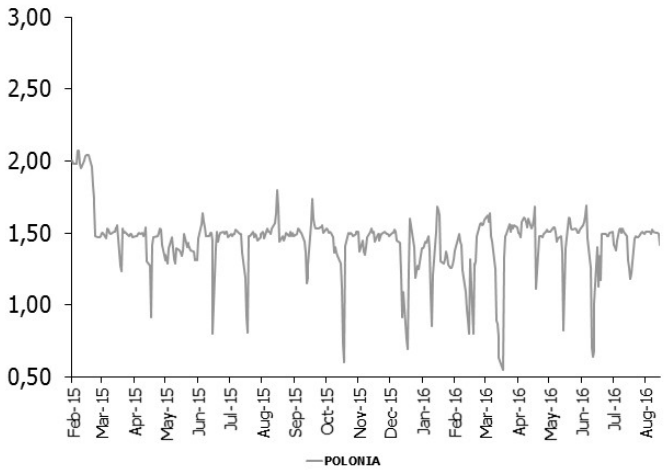
The final stage of monthly reserve period approaches so cash will stay low till 30th August when additional operation will take place.

Ref rate vs Polonia averages:
30 day: 5 bp
90 day: 8 bp





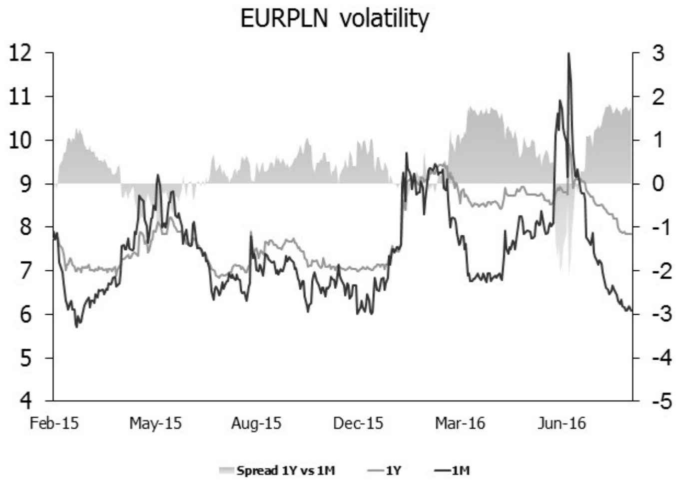




Forex

Spot – PLN weaker It was a very slow week for FX, and EUR/PLN was no exception. We had an extremely tight range, 4.2800-4.3350, and realized volatilities were at their lower bands. The odds for rate cuts are slightly higher, one could read from MPC minutes. Moody's warned Poland about the potentially rating-negative consequences of Constitutional Court crisis. PLN was slightly weaker as a result, but the move was slow and orderly. It is still hot and sunny in Warsaw, and looks like the holiday mood is still on.

Options – EUR/PLN vols – lower again Vols are lower again, and slightly weaker PLN was not able to prevent that. The move was too slow and too orderly to make options sellers worry. 1 month EUR/PLN ATM mid is 5.7% (0.2% lower), 3 months EUR/PLN are 6.3% (0.1% lower) and finally 1 year is fixing at 7.8% (0.1% lower). The skew and currency spread were at the same level as week before. The Jackson Hole event supported short term USD/PLN vol, but there was more short covering than anything else.



Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.23 / 4.35
USD/PLN: 3.75 / 4.00

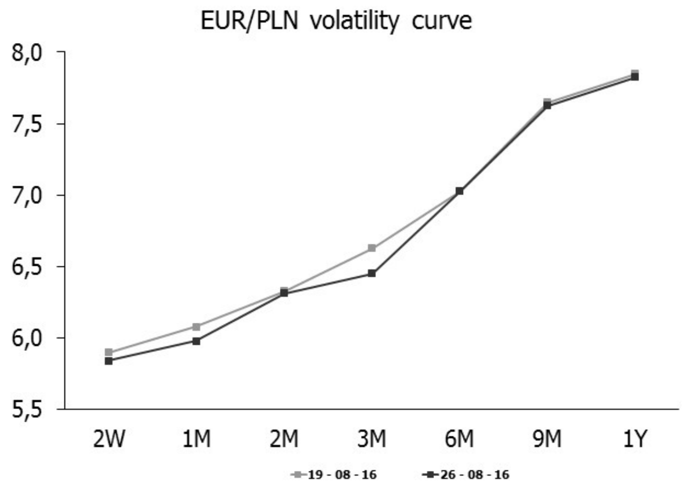
Spot New position: Short EUR/PLN.

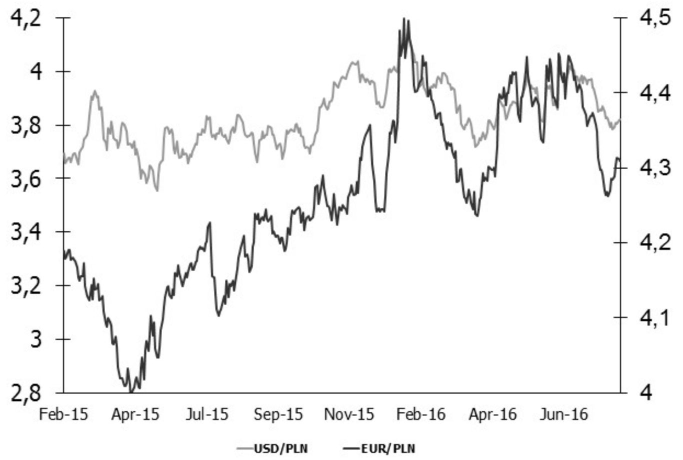
We are short at 4.29 and 4.32. The stop is at 4.35 and the hopes are still to see 4.2300.

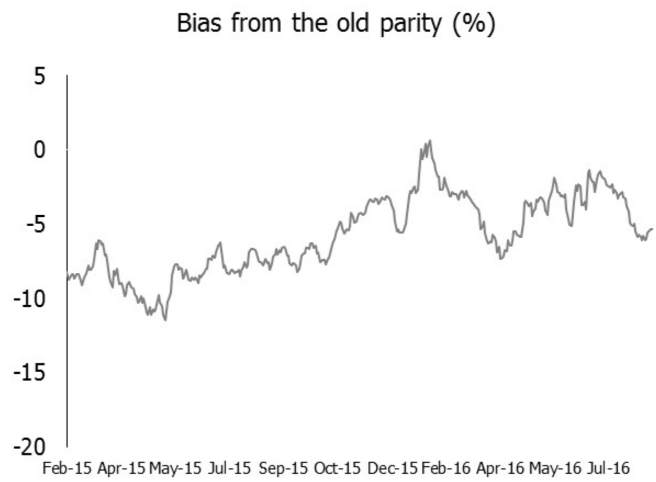
The correction higher in EUR/PLN was the most likely positioning-driven. Longs in PLN were trimmed and we are now much more neutrally positioned. The momentum is simply not there. We have to wait until market participants come back from their holidays to find the direction.

Options Selectively long Vega

Implied volatilities have come off significantly over the past weeks. For some tenors realized volatilities are significantly higher than implied volatilities (for example 2m 9.3% realized versus 6.2% implied, 3m 8.8% realizedversus 6.4% implied). There is a lot of uncertainty surrounding Brexit, postponed decision on forced conversion of CHF mortgages, Constitutional Court conflict, the U.S. elections, so we stick to our position – we have still selective longs in backend EURPLN curve.







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
8/19/2016	1.90	1.71	1.94	1.69	2.00	1.71	1.65	1.57	1.50	1.47	1.46	1.56
8/22/2016	2.05	1.71	1.90	1.69	2.05	1.71	1.66	1.58	1.50	1.47	1.44	1.57
8/23/2016	1.94	1.71	1.94	1.69	2.00	1.71	1.66	1.58	1.51	1.48	1.46	1.57
8/24/2016	1.85	1.71	1.87	1.69	1.91	1.71	1.66	1.58	1.51	1.48	1.46	1.57
8/25/2016	1.94	1.71	1.98	1.69	2.04	1.71	1.67	1.58	1.52	1.49	1.47	1.58

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
32W TB	3/14/2016	11/30/2016	99.04	1.35	1500	1757	1692
OK1018	8/18/2016	10/25/2018	96.47	1.67	2000	2412	1947
PS0421	8/18/2016	7/25/2021	98.31	2.11	3500	4968	3844
DS0726	8/18/2016	7/25/2026	98.23	2.70	2000	3405	2159

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
8/19/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/22/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/23/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/24/2016	1.710	1.474	1.635	1.638	1.990	2.290	2.447	2.985
8/25/2016	1.710	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
8/19/2016	6.08	6.63	7.03	7.85	7.85	2.30	0.59
8/22/2016	6.18	6.63	7.03	7.85	7.85	2.30	0.59
8/23/2016	6.13	6.60	6.98	7.85	7.85	2.33	0.65
8/24/2016	6.08	6.63	7.00	7.85	7.85	2.24	0.59
8/25/2016	5.98	6.45	7.03	7.83	7.83	2.24	0.59

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/19/2016	4.2884	3.7905	3.9596	3.7847	1.3809	0.1587
8/22/2016	4.3030	3.8090	3.9555	3.7812	1.3870	0.1592
8/23/2016	4.3139	3.8061	3.9619	3.7998	1.3889	0.1596
8/24/2016	4.3116	3.8174	3.9630	3.8109	1.3915	0.1595
8/25/2016	4.3095	3.8190	3.9575	3.8056	1.3916	0.1595

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