September 23, 2016

Polish Weekly Review

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Comment on the upcoming data and forecasts

This week's only macro data will be published on Friday. However, our forecast of *flash* CPI still needs to be tailored using latest high-frequency data. One should expect a big uptick in inflation due to low statistical base in the prices of energy commodities.

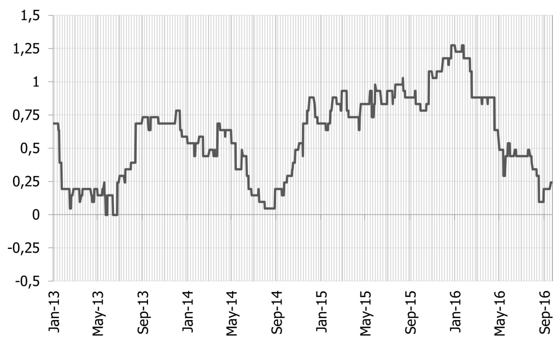
Polish data to watch: September 26th to September 30th

Publication	Date	Period	mBank	Consensus	Prior
CPI y/y (%) *flash*	30.09	Sep			-0.8

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	10/6/2016	2000	1.647	9/1/2016
5Y T-bond PS0721	-	3500	2.114	8/18/2016
10Y T-bond DS0726	10/6/2016	3000	2.791	9/1/2016
15Y T-bond WS0428	-	200	3.027	7/7/2016

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



Comment

Slightly up as industrial output surprised to the upside (see the Economics section for a detailed comment). Next week brings the flash CPI release.

* 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 early 2017, and private investment seems to be locally, negatively affected by spillovers from public investment gap, lower absorption of EU funds and political uncertainty. However, over the medium term 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 are still a possibility (most likely in early 2017). 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 has moved towards the lower bound of its range, thanks to (relatively) hawkish MPC and global easing of monetary conditions. Due to the weakness in exports and country risks still present, we expect Zloty to remain weak for the time being.
- The prevailing event risk for PL assets, the CHF conversion, moved to the background, as its details are unlikely to be announced soon.
- As the expectations for Fed hike moved towards December, market focus is now on US elections and their possible impact on the economy and geopolitics. With the race as tight as it is now, the elections pose a major risk for EM assets, probably higher than Brexit.

mBank forecasts

	2012	2013	2014	2015	2016 F	2017 F
GDP y/y (%)	1.6	1.3	3.3	3.4	3.0	3.2
CPI Inflation y/y (average %)	3.7	0.9	-0.1	-0.9	-0.6	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	1.50	1.25

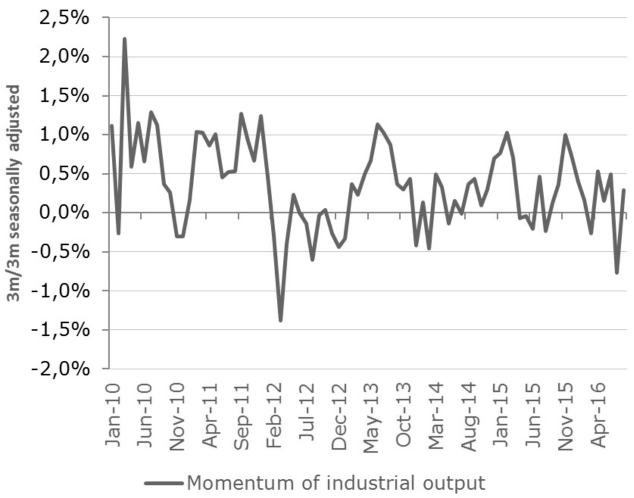
	2016 Q1	2016 Q2	2016 Q3 F	2016 Q4 F	2017 Q1 F	2017 Q2 F	2017 Q3 F	2017 Q4 F
GDP y/y (%)	3.0	3.1	2.7	2.5	2.7	3.1	3.4	3.5
Individual consumption y/y (%)	3.2	3.3	3.8	4.2	4.3	4.1	3.8	3.5
Public Consumption y/y (%)	4.4	4.4	4.0	1.0	2.4	2.4	2.4	2.4
Investment y/y (%)	-1.8	-4.9	-6.5	-4.0	-2.0	2.0	6.0	6.5
Inflation rate (% average)	-0.9	-0.9	-0.7	0.3	0.9	1.3	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	1.50	1.25	1.25	1.25	1.25
Wibor 3M (% eop)	1.67	1.71	1.71	1.71	1.44	1.44	1.44	1.44
2Y Polish bond yields (% eop)	1.45	1.65	1.65	1.55	1.35	1.30	1.30	1.30
10Y Polish bond yields (% eop)	2.84	2.91	2.90	2.85	2.80	2.80	2.80	2.80
EUR/PLN (eop)	4.24	4.38	4.30	4.35	4.35	4.30	4.25	4.25
USD/PLN (eop)	3.73	3.94	3.84	3.95	4.03	3.98	3.94	3.94

F - forecast

Economics

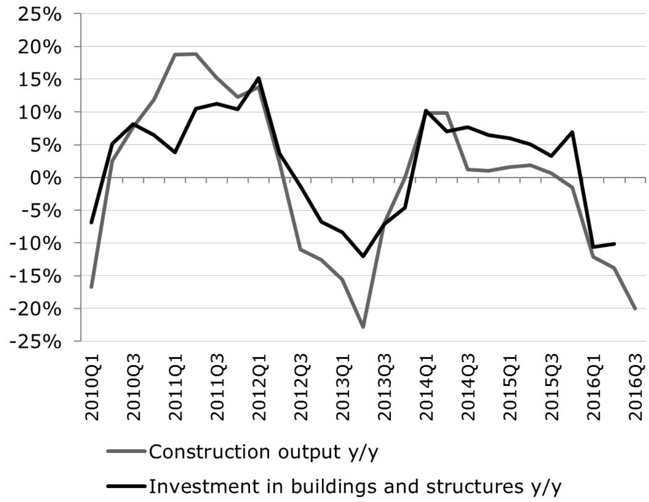
No more hopes for a growth boost in second half of the year

Industrial output grew by a solid 7.5% y/y in August, beating market forecasts and even our upbeat expectations (5.1 and 6.7%). Such a big swing in annual growth rate was to be expected on the basis of calendar alone (working day difference increases from -2 to +1 y/y) and catching up in auto plants, but low statistical base (the 2015 heat wave caused production and supply chain disruptions) also contributed. Forecasters tend to underestimate the effects of so extreme changes in calendar – and this time is not different. The more adequate measure of economic activity would be the seasonally adjusted m/m change - which amounts to +2.1%. Averaging over three months, to filter out e.g. the auto plant closures, leads to the conclusion that the momentum of industrial output is still close to zero (see the graph below).

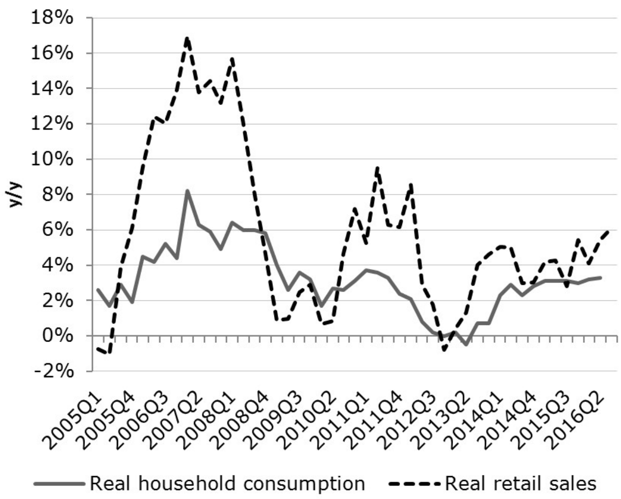


In the coming months industrial output growth will not be as impressive - calendar effects will be more neutral, while base effects (the end of EU-financed projects in late 2015, including big-ticket investment in trains) will dampen production considerably. One must also take into consideration the downtrend in Polish exports which must be reflected in industrial output figures – perhaps that is what we're seeing.

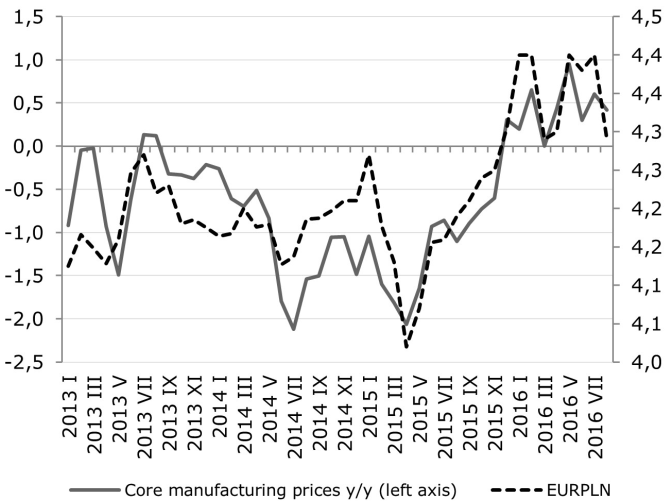
Construction output declined by 20.5% in annual basis and here forecasters (including us) even failed to anticipate the direction of change, as all forecasts pointed to slight acceleration in construction. After seasonal adjustments, construction output declined by a shocking 5.5% m/m. This speaks for itself, therefore it is useful to concentrate on the implications of today's construction data. First, there is no rebound in investment in Q3. On the contrary, it likely even deepened. Second, the trajectory of investment and construction output in 2016 is reminescent of 2012/2013 slowdown / investment recession. A perceptive analyst should also see that this time it is happening faster and could even be longer. Unfreezing motorway tenders is a step in the right direction but it is a drop in the ocean.



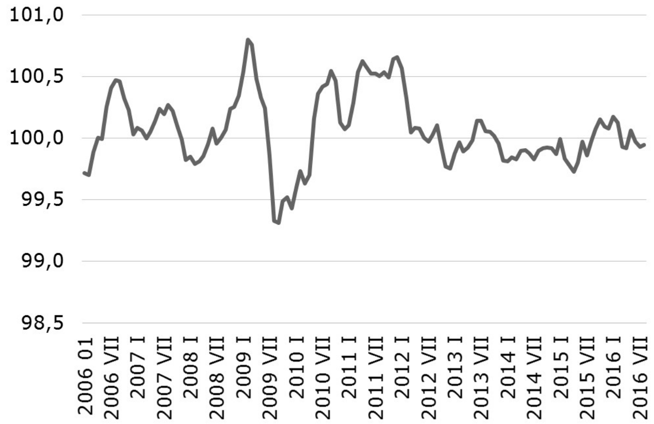
Retail sales rose by 5.6% y/y in August, matching our forecast. We believed that households would rush for consumption of goods just before the end of holidays and after they had accumulated some buffer savings and had enjoyed holiday spending that concentrated on services in the last 2 months. It seems we were right, but the positive difference in working days helped as well. Real retail sales growth (7.8%) was still below wage bill growth (wages times employment corrected by inflation/deflation) that is running close to 8-10% this year. So, we are not witnessing something spectacular at all. The shape of consumption path is going to top at the turn of 2016/2017. However, with current magnitude it is not going to be sufficient to make up for gloomy investment demand. Hence, prepare yourselves for sub 3% growth in H2 2016.



Producer prices went down by 0.1% y/y in August. The reading was higher than our forecast. However, apart from minor differences in the short-term, we feel that our mid-term view is left intact. First of all, the growth of producer prices (ex oil and coke, determined by exogenous factors mostly) is close matching exchange rate (see the graph). Secondly, the momentum of producer prices is very low (another graph) – annual growth rises solely on base effects. Last but not least, global business activity may have passed a local peak, local growth is tanking on the basis of poor infrastructure spending; risks to exports are skewed to the downside. These are not times when pricing power of local firms can be built up again. Therefore, we still think the disinflationary equilibrium is here to stay.



Momentum in manufacturing prices ex coke and oil, 6mma

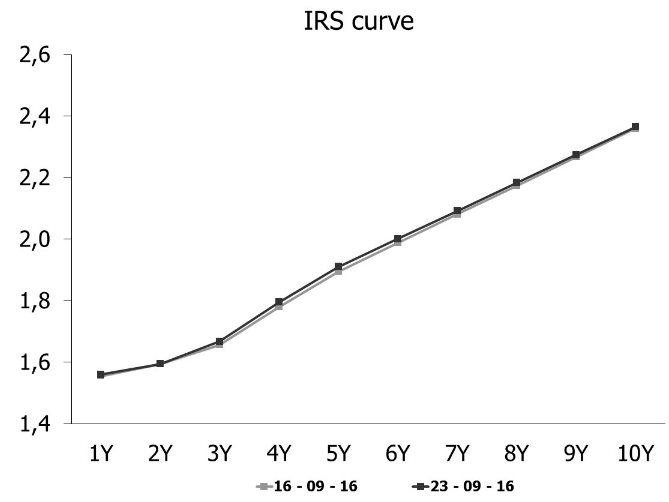


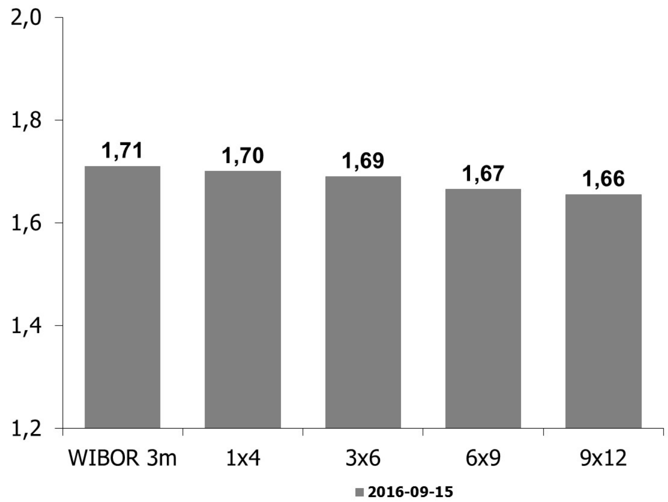
Extrapolation of high-frequency readings suggest Q3 growth is heading towards 2.5%. All this happens when output and sales are running at levels not seen for months, inflated by working days and statistical bases. This is not the preferred scenario of the MPC and it may be hard to internalize instantaneously due to the simple fact, that MPC did all it can to guide market expectations the other way. . . We think that rate cuts scenario dominates the one of stable rates in the next 6-9 months.

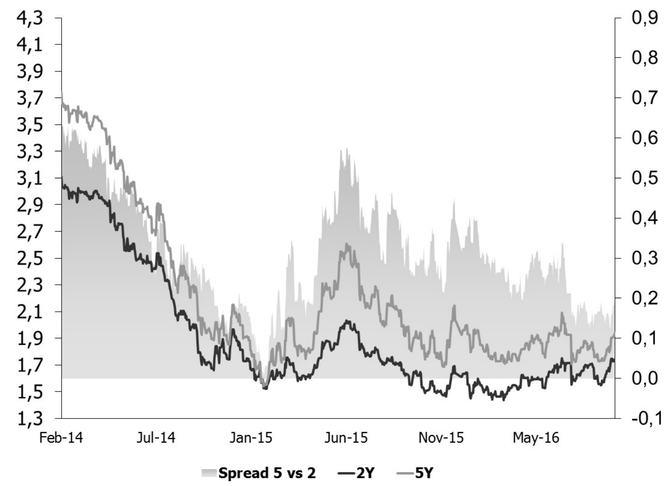
Fixed income

Great switching auction

Ministry of Finance sold 12.74 bio bonds, in floaters 2.81 bio of WZ0120 and 3.99 bio of WZ0126 and 5.94 bio of 5y fixed rate PS0721 at switching auction yesterday. We had an impressive strong auction, spread PS0721/DS0726 has narrowed to 54bps from 59bps and looks cheap comparing to the smoothed yield curve. ASW 2y/OK1018 1/-1, 5y/PS0721 35/33, 10y/DS0726 55/53 are expensive, while floaters WZ0120 (spread for live 15 bps) and WZ0126 (spread for live 64 bps) cheap comparing to the curve. Thursday's redemption 7.2 bio in PS1016, 4.16 bio in WZ0117 and 661.6 mio in PS0417 will generate demand for short term bonds up to 3y and floaters next week. Short bonds covering due to end of the month will also boost bullish on short end.







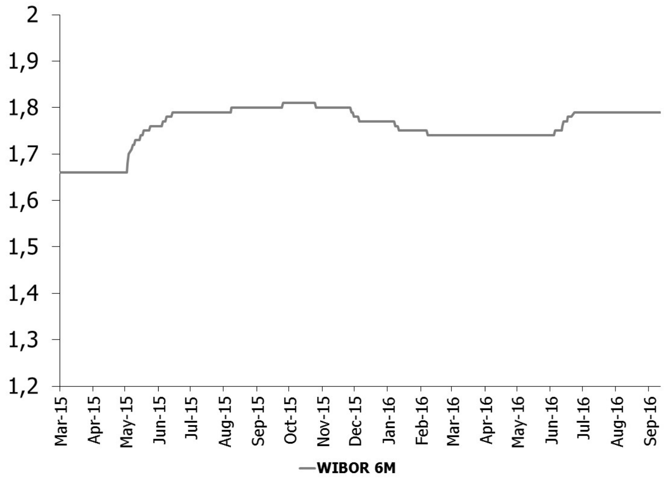
Money market

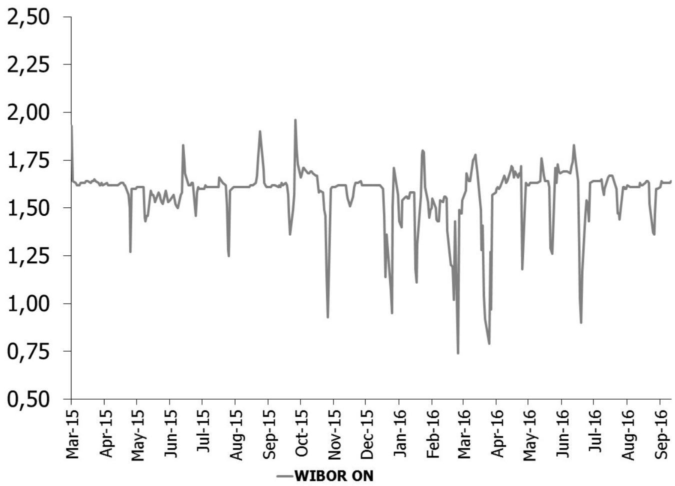
Fed

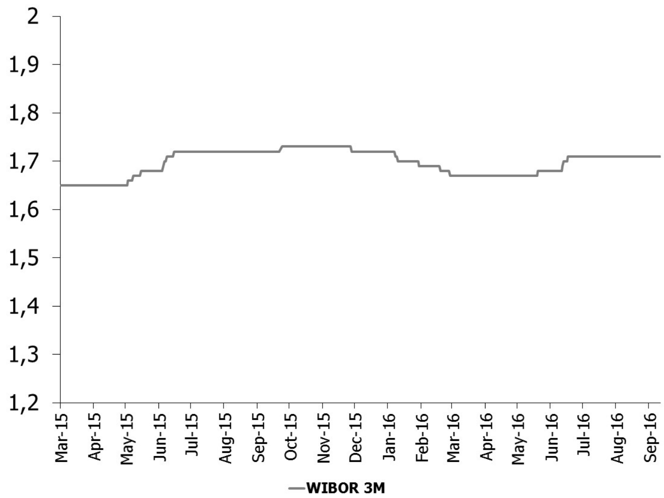
Last week's Fed decision switched markets into risk-on mode all over the world. Poland wasn't an exception and rates reversed gains from previous weeks. Curve is trading 5-7 bp lower with some flattening tendency. We should still follow global trends next week till the release of flash CPI on Friday.

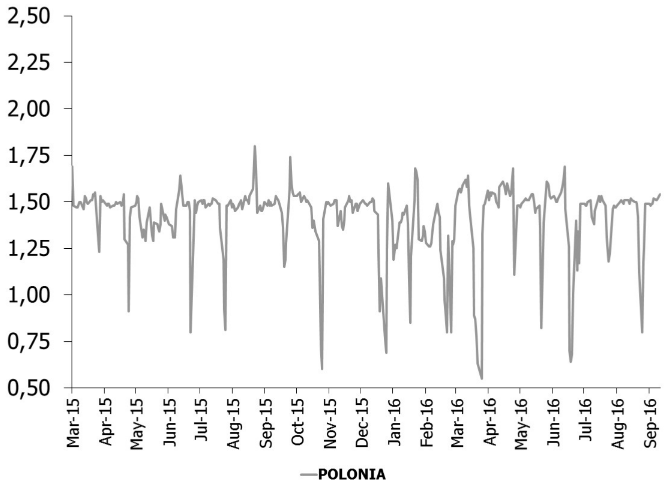
Money market looks really nervous and fragile in the last days. Big banks are taking cash instead of supporting liquidity and todays OMO results only added to this weirdness. NBP accepted 65 bio of bids out of 70 placed and we wouldn't like to see what would happen if all the bids were accepted. Last day of reserve period is on Thursday and all cash will stay in NBP till Friday.

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





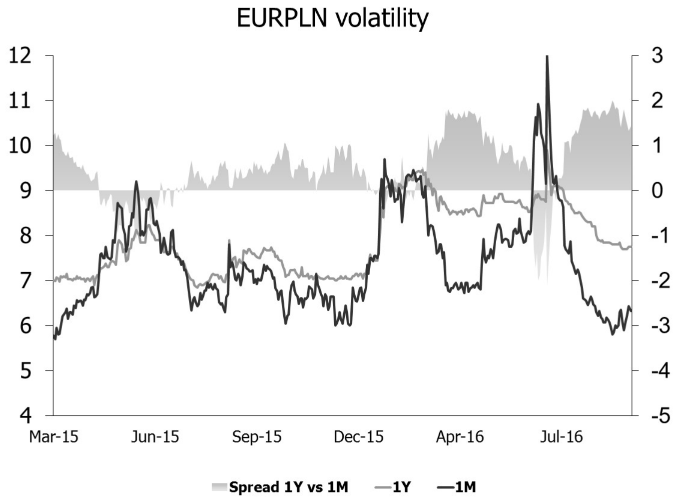




Forex

Spot – PLN is in demand The FOMC inaction triggered further gains of the Zloty. EUR/PLN briefly touched 4.2730 before mild profit taking, which took us back to 4.29. There is little to cling on market-wise, as the PLN is still dragged and pulled by global events / sentiment. The Polish factor is almost ignored for the time being. We are sceptical about that rally, 4.25-4.27 is the next strong EUR/PLN support zone. We are still advocates of the rangy nature of EUR/PLN, which should now fluctuate between 4.26-4.36.

Options – EUR/PLN vols – lower The realized volatility on main PLN crosses (against EUR and USD) is at its lows and that dragged both curves down. The USD/PLN curve was also affected by the FOMC's refusal to rise rates. Hence, more sideways, erratic price action will follow. 1 month EUR/PLN ATM mid is at 5.5% (0.5% lower), 3 months EUR/PLN are at 6.2% (0.5% down) and, finally, 1 year is fixing at 7.4% (0.4% lower). The skew was slightly better offered.



Short-term forecasts

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

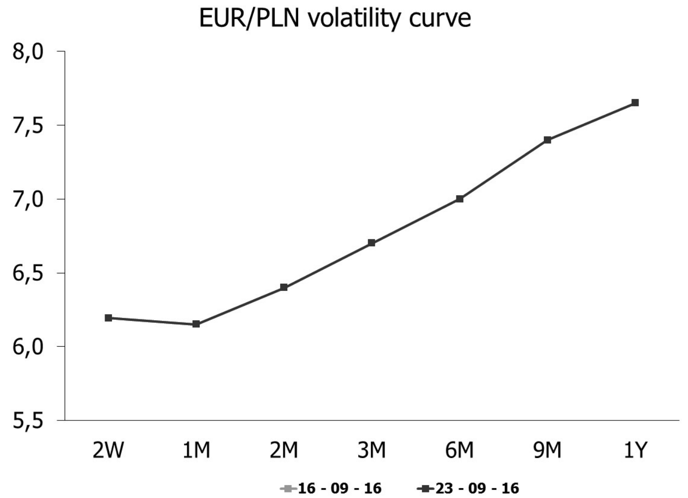
Spot Position: Long EUR/PLN.

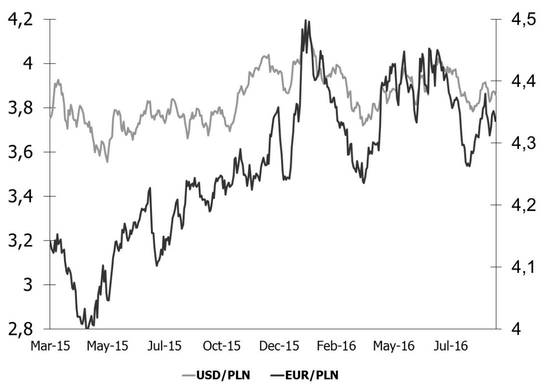
We are long EUR/PLN from 4.3170, and 4.2870. The stop is at now at 4.2550 and we are hoping to see 4.38/4.40 and, depending on the momentum, possibly 4.41/4.43.

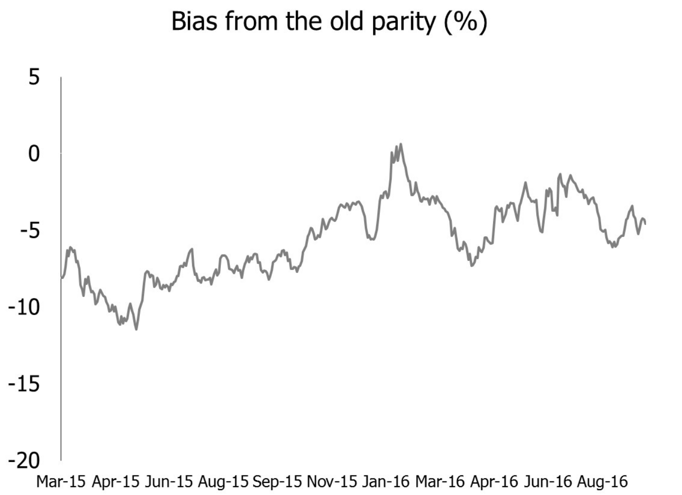
We are long and wrong in EUR/PLN. We are keeping the position, but we plan to be disciplined with stop execution. No obvious market-moving event on the horizon. The Polish politics is still the possible "black swan" for PLN. The government reshuffle plans are hitting the wires, which should be neutral, unless it will involve Morawiecki in person.

Options Selectively long Vega

Implied volatilities have come off significantly over the past weeks. There is a lot of uncertainty surrounding Brexit, the postponed decision on forced conversion of CHF mortgages, Constitutional Court conflict, 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
9/16/2016	2.02	1.71	1.85	1.69	2.05	1.71	1.70	1.69	1.67	1.66	1.66	1.74
9/19/2016	2.02	1.71	2.07	1.69	2.07	1.71	1.70	1.71	1.68	1.66	1.66	1.75
9/20/2016	1.88	1.71	1.95	1.69	2.07	1.71	1.70	1.68	1.64	1.61	1.60	1.72
9/21/2016	1.79	1.71	1.87	1.69	1.97	1.71	1.70	1.68	1.64	1.62	1.61	1.72
9/22/2016	1.86	1.71	1.97	1.69	2.10	1.71	1.70	1.70	1.63	1.62	1.60	1.72

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
9/16/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
9/19/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
9/20/2016	1.710	1.474	1.635	1.578	1.960	2.232	2.405	2.949
9/21/2016	1.710	1.474	1.635	1.638	1.990	2.290	2.447	2.985
9/22/2016	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
9/16/2016	6.18	6.65	6.95	7.60	7.60	2.14	0.61
9/19/2016	6.13	6.55	6.85	7.53	7.53	2.14	0.61
9/20/2016	6.13	6.53	6.83	7.50	7.50	2.07	0.60
9/21/2016	6.03	6.50	6.85	7.50	7.50	2.07	0.67
9/22/2016	5.68	6.30	6.70	7.40	7.40	2.07	0.60

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
9/16/2016	4.3244	3.8497	3.9548	3.7738	1.3968	0.1600
9/19/2016	4.3071	3.8586	3.9350	3.7881	1.3996	0.1593
9/20/2016	4.3019	3.8438	3.9350	3.7786	1.3935	0.1592
9/21/2016	4.3034	3.8601	3.9510	3.7895	1.3947	0.1593
9/22/2016	4.2856	3.8128	3.9330	3.7840	1.3948	0.1585

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