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Polish Weekly Review

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Comment on the upcoming data and forecasts

On Wednesday CSO will publish final GDP data for third quarter (this time with all components) as well as flash CPI estimate for November. When it comes to the first figure, we expect that GDP growth slowdown is a result of large drop in investment activity balanced partially by stable consumption (driven by "Family 500+" program). CSO data will allow us to confront this view given also net exports and inventories contributions. On Thursday Polish manufacturing PMI for November will be published.

Polish data to watch: November 28th to December 2nd

| Publication | Date | Period | mBank | Consensus | Prior |
|--------------------------|-------|--------|-------|-----------|-------|
| GDP y/y (%) <i>final</i> | 30.11 | Q3 | 2.5 | 2.5 | 3.1 |
| CPI y/y (%) <i>flash</i> | 30.11 | Nov | | | -0.2 |
| Manufacturing PMI (p.) | 02.12 | Nov | | | 50.2 |

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 | 12/15/2016 | 2000 | 1.742 | 10/6/2016 |
| 5Y T-bond PS0722 | - | 4000 | 2.499 | 11/17/2016 |
| 10Y T-bond DS0727 | 12/15/2016 | 4000 | 3.098 | 10/6/2016 |
| 15Y T-bond WS0428 | - | 200 | 3.027 | 7/7/2016 |

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



Comment

Polish surprise index moved further down fuelled by weaker industrial output data. Next week brings plenty of opportunities to surprise with final GDP, flash CPI and manufacturing PMI data.

* 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. Despite weak Zloty, exports growth ground into a halt. Public infrastructure outlays have shifted towards 2017, and private investment seems to be locally, negatively affected by spillovers from public investment gap, lower absorption of EU funds and political uncertainty. Hence, we expect 2-3 quarters of subpotential growth.
- 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 (but MPC is very unwilling to ease and global trend is for tightening). We expect the MPC to finally acknowledge downside risks for Polish GDP growth.

Financial markets

- Global reflation trades weakened the Zloty by raising risk-free rates and encouraging capital outflows from EM assets. 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.
- Stronger dollar and upcoming Fed hike (December) hold in check any strengthening of Polish zloty.

mBank forecasts

| | 2012 | 2013 | 2014 | 2015 | 2016 F | 2017 F |
|-------------------------------------|------|------|------|------|--------|--------|
| GDP y/y (%) | 1.6 | 1.4 | 3.3 | 3.9 | 2.5 | 3.0 |
| CPI Inflation y/y (average %) | 3.7 | 0.9 | -0.1 | -0.9 | -0.6 | 1.3 |
| 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 | 2016 | 2016 | 2016 | 2017 | 2017 | 2017 | 2017 |
|--------------------------------|------|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 F | Q4 F | Q1 F | Q2 F | Q3 F | Q4 F |
| GDP y/y (%) | 3.0 | 3.1 | 2.5 | 1.7 | 2.2 | 2.8 | 3.4 | 3.5 |
| Individual consumption y/y (%) | 3.2 | 3.3 | 3.8 | 4.6 | 4.3 | 4.0 | 3.8 | 3.5 |
| Public Consumption y/y (%) | 4.4 | 4.4 | 4.0 | 1.0 | 3.0 | 3.0 | 3.0 | 3.0 |
| Investment y/y (%) | -1.8 | -4.9 | -6.5 | -4.5 | -2.5 | 3.5 | 6.0 | 6.0 |
| Inflation rate (% average) | -0.9 | -0.9 | -0.8 | 0.2 | 1.3 | 1.4 | 1.2 | 1.1 |
| Unemployment rate (% eop) | 9.9 | 8.7 | 8.3 | 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 | 1.76 | 1.80 | 1.70 | 1.60 | 1.60 | 1.70 |
| 10Y Polish bond yields (% eop) | 2.84 | 2.91 | 2.92 | 3.60 | 3.50 | 3.40 | 3.50 | 3.50 |
| EUR/PLN (eop) | 4.24 | 4.38 | 4.30 | 4.50 | 4.45 | 4.35 | 4.25 | 4.25 |
| USD/PLN (eop) | 3.73 | 3.94 | 3.82 | 4.21 | 4.20 | 4.14 | 4.05 | 4.05 |

F - forecast

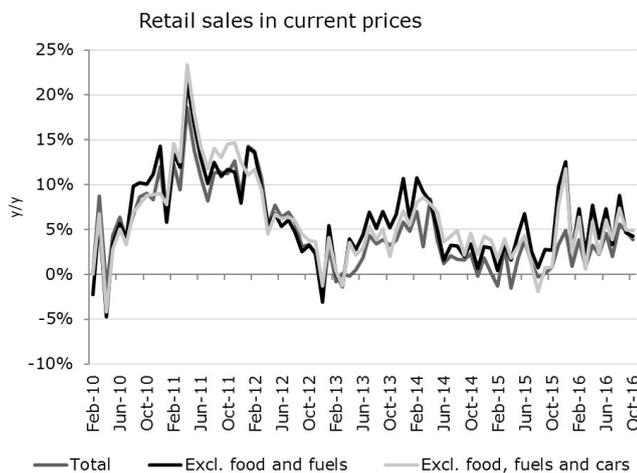
Economics

Further slowdown of Polish economy: GDP growth in Q4 even lower than 2%. Producer prices propelled only globally.

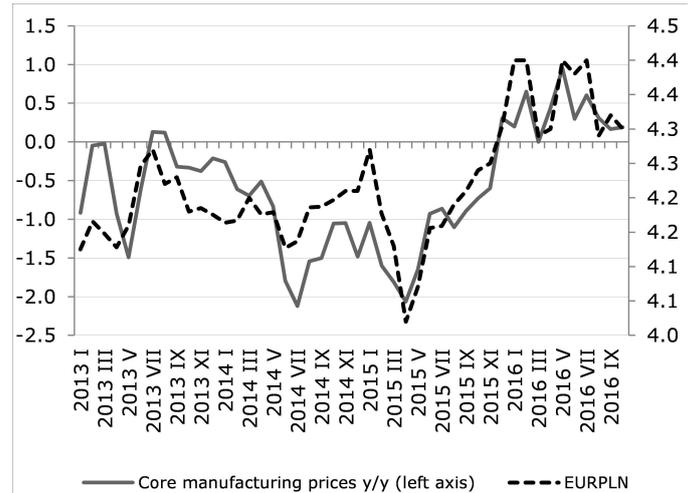
Industrial production fell in October by 1.3% on a yearly basis, after growing by 3.2% in September. After seasonal adjustment this difference is slightly lower: (+1.3% vs. +3.3%). Most (20 out of 34) sections expanded, however rebound in energy and coke production may be somehow connected with deflators. Mostly pro-cyclical sections contracted.

Lower industrial production is overall a result of slowdown of foreign trade in Germany (we see a downward trend there since several quarters) and setback in investment activity in Poland. Consumption fueled by government "Family 500+ program" is not growing as fast as expected. Moreover, it is boosting imports rather than domestic production.

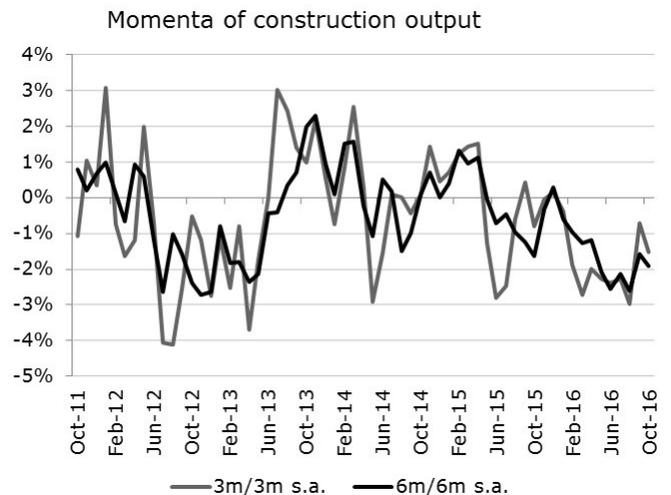
Retail sales decelerated to 3.7% y/y. We were more optimistic but auto sales and "other" category failed to deliver in October (both recorded deep decreases of 4% and 9.7% respectively). Both sections are heavyweights and their chief characteristic is substantial volatility. As long as environment remains sales (consumption) supportive – high consumer confidence, dynamic growth of real incomes, social transfers) – we will treat downside surprises as outliers and bet for an above-trend rebound the following month. So far, however, everything below trend supports weakness in Q4 and the adjustment of market forecasts towards our target.



Producer prices accelerated to 0.6% y/y beating our forecast. The growth is globally driven, though and concentrates on energy related industries (coal, coke, oil) which are galloping 5-6% month by month. Excluding those, core manufacturing is running close to 0% on annual basis and monthly variations are driven by exchange rate (see chart). It is worth to note that such a combination of price increases may be profit-negative for companies (ceteris paribus). In such a way it should be supportive for lower, not higher NBP rates.



Construction output declined by 20.7% y/y, more than both market consensus and our forecast had assumed (ca. 14 – 15%); after seasonal adjustment it fell by 17.5%. Construction output erased previous month's uptick almost completely: -3% m/m after +3.5% in September. Wet and cold October could not be the sole explanation for this drop as almost all sections surprised on the downside. Outlook for construction sector looks now even more gloomy. We do not see any significant signs of rebound, municipal and railway project still are lagging.



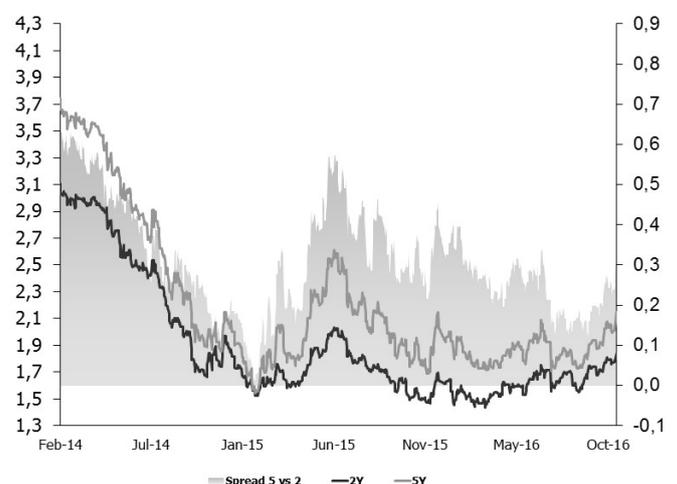
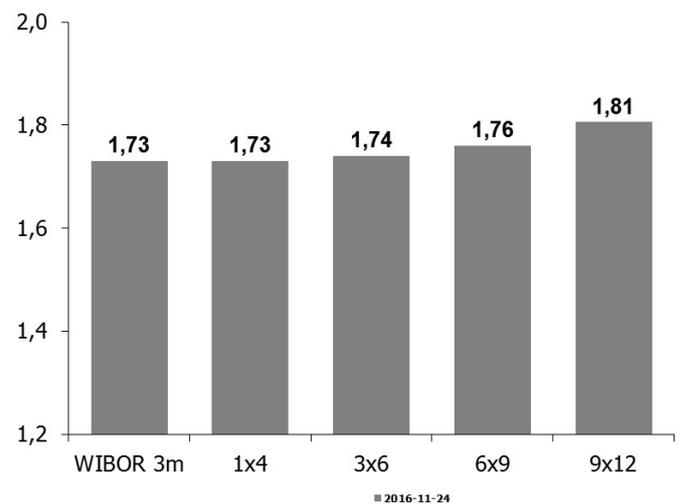
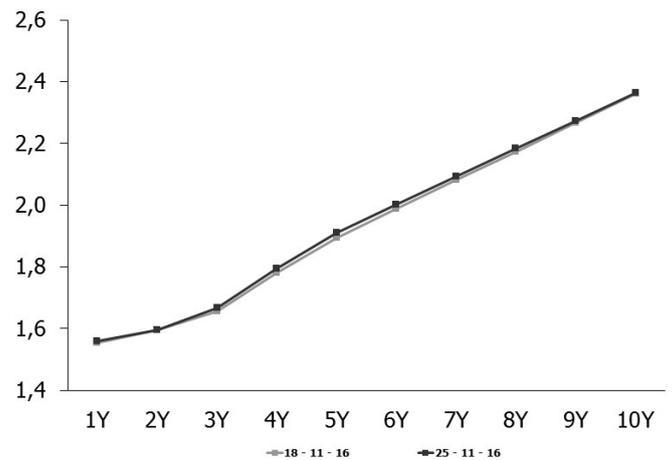
The momentum of industrial output stays negative. Retail sales are proceeding slower than expected given the magnitude of exogenous support. Investment activity is still in doldrums. We think that Polish GDP growth will fail to reach 2.0% in Q4 (given latest information we estimate it at 1.7%). Statistical base effects, evident mostly in public consumption, only reinforce the scenario. Soft patch has arrived to Polish economy, just as we expected. NBP inflation projection, even though a fresh one, seem to had become obsolete within a week time. Deeper slowdown should at least be a source of discomfort for the MPC as current rhetoric of strong growth does not seem to be matching reality. Correction in NBP rates is still possible even though investors dived fully in U.S. reflation trends. At least everyone should now admit that rate hikes currently priced-in are a nonsense. Substantial steepness of Polish yield curve should be regarded as an opportunity now. We think that even with the extension of current global trends, Polish yields should not rise substantially from current levels.

Fixed income

At the yields' heights

Last Friday we have seen highest levels on POLGB since 2014. DS0726 was at 3.75%, PS0721 at 2.91% and OK1018 at 1.93%. Today yields are 5-15 bps lower and curve is much flatter (PS0721/DS0726 is traded at 72 bps). Next auction is in December, only OK1018 will be on the offer. Liquidity is very poor, volatility is very high. People are waiting for Christmas. We expect bumpy ride till the end of year. Market is waiting for fresh inflows to EM Funds, if we don't see them, we won't come back to lower yields.

IRS curve



Money market

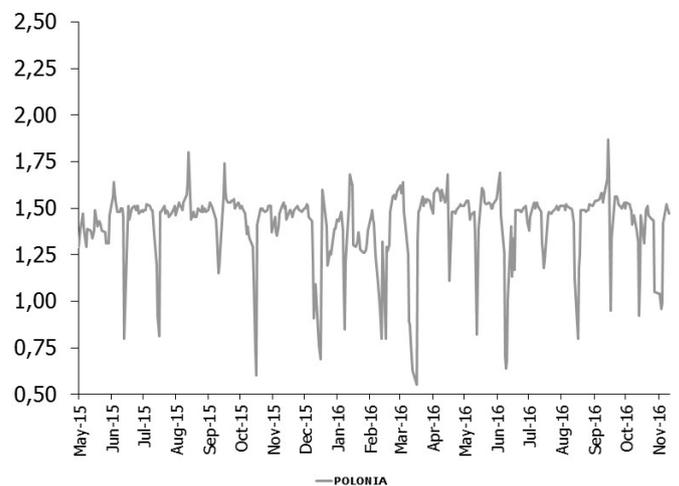
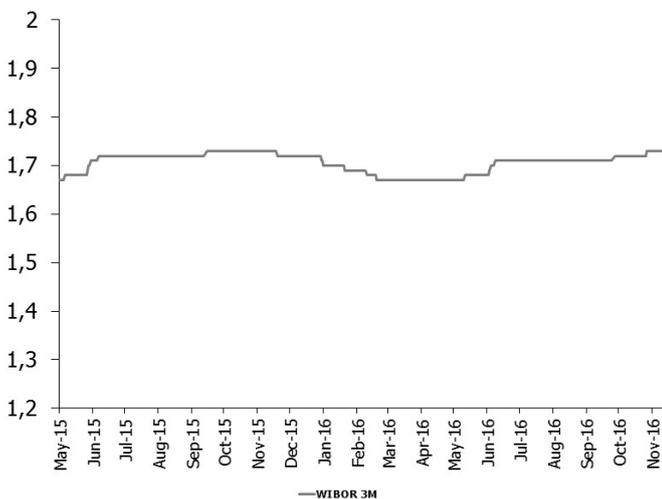
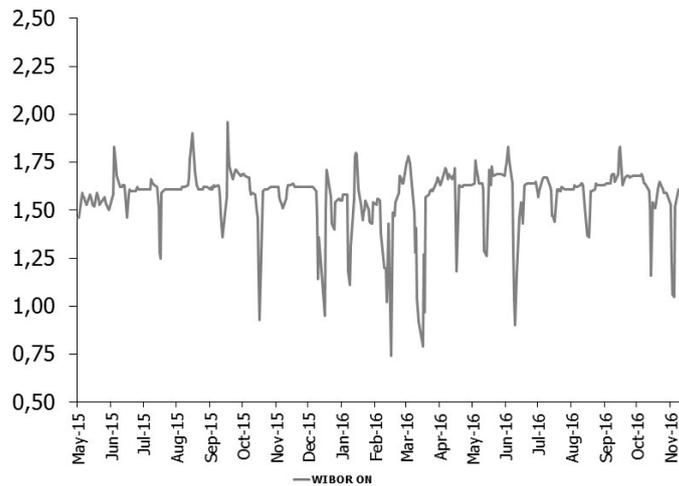
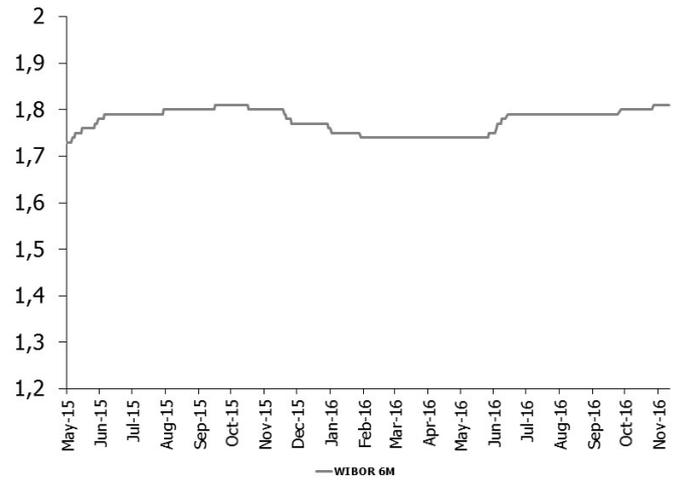
Is this really stability?

Bonds stabilized on lower levels with OK1018 yielding 1.90%. Today, Ministry of Finance announced that they will offer only short bonds on December's switching auction. This supply may affect market, although switch auctions don't have minimum notional and 40 bp pick-up to shortest bonds should lure at least some investors.

On cash market we are heading into month's end with about 3bio spare cash. That's not a spectacular surplus but ON should stay low.

Ref rate vs Polonia averages:

- 30 day: 18 bp
- 90 day: 8 bp



Forex

Spot – EUR/PLN consolidating gains EUR/PLN was not able to break 4.4500-4.4700 resistance zone, at least at the first attempt. As a result it slipped to 4.4040 before consolidating. It does not mean that the upward trend is over. Technically, while above 4.3800, we still assume it is more likely that we will go higher. The PLN weakness is mainly driven by USD strength, and that's likely to persist. We see 4.3800-4.4800, as the possible range. We would be more keen to buy EUR/PLN below 4.40 than sell EUR/PLN spikes. The Italian referendum is looming on the horizon as the new "event risk".

Options – EUR/PLN vols consolidating The market is regaining its composition, the vols are still high with only minor signs of melting (especially in USD/PLN). 1 month EUR/PLN is now 7.4% mid (0.4% lower), 3 month EUR/PLN are 7.4% (unchanged) and finally 1 year is 7.7% (0.1% lower). The currency spread (USD/PLN vol minus EUR/PLN vol) is lower by roughly 0.25%. Skew is unchanged.

Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.38 / 4.53

USD/PLN: 3.90 / 4.30

Spot Position: None.

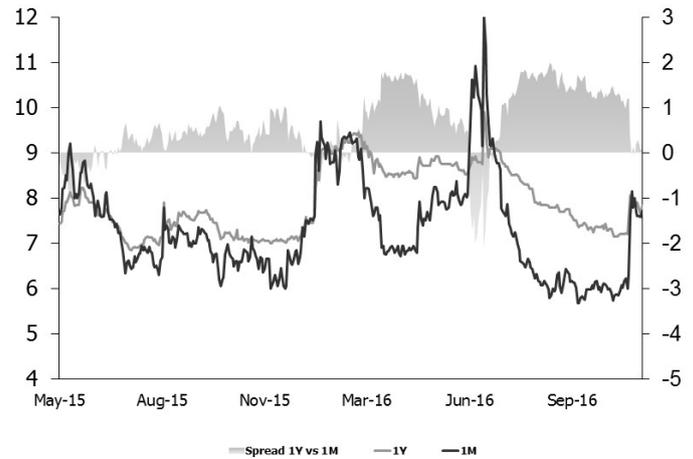
We are still sidelined for the time being but the potential risk reward scenario makes us more likely to buy dips than fade spikes. Ideally, we would like to buy EUR/PLN at 4.4050 and we are ready to add at 4.3800 with stop loss at 4.3575. We would set profit taking at 4.48, and – depending on the momentum – possibly 4.50+.

Options Vol – Selectively long Vega

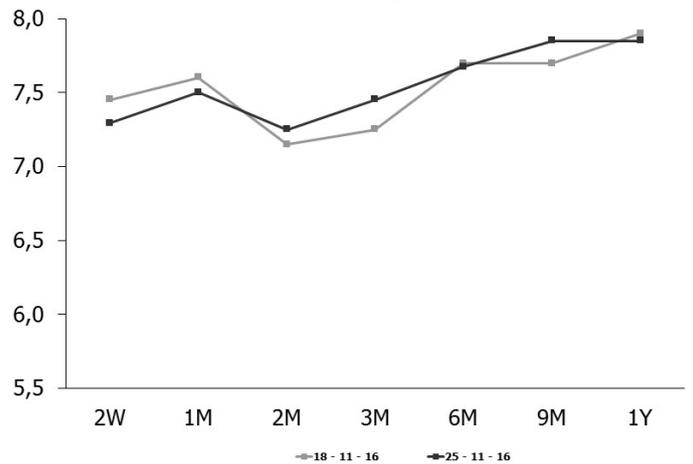
We are keeping our selective long in EUR/PLN Vega (6 months and 12 months) but only in 30% of our risk limits. On one hand there is FOMC, and Italian referendum, but with fast approaching Christmas, we are prefer to keep position light. We would be buyers of back-end if it revisit this year's lows, or sellers of the front-end if some panic /risk off hits the market.



EURPLN volatility



EUR/PLN volatility curve



Bias from the old parity (%)



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 |
| 11/18/2016 | 2.08 | 1.73 | 2.12 | 1.71 | 2.17 | 1.75 | 1.74 | 1.74 | 1.76 | 1.77 | 1.82 | 1.84 |
| 11/21/2016 | 2.10 | 1.73 | 2.14 | 1.71 | 2.18 | 1.75 | 1.73 | 1.74 | 1.75 | 1.79 | 1.83 | 1.83 |
| 11/22/2016 | 1.62 | 1.73 | 1.84 | 1.71 | 1.90 | 1.75 | 1.73 | 1.75 | 1.74 | 1.73 | 1.78 | 1.82 |
| 11/23/2016 | 1.52 | 1.73 | 1.93 | 1.71 | 1.98 | 1.75 | 1.73 | 1.76 | 1.76 | 1.76 | 1.82 | 1.83 |
| 11/24/2016 | 1.70 | 1.73 | 1.78 | 1.71 | 1.81 | 1.75 | 1.73 | 1.74 | 1.76 | 1.81 | 1.84 | 1.84 |

| 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 | 10/6/2016 | 10/25/2018 | 96.54 | 1.74 | 2000 | 4838 | 2448 |
| PS0421 | 8/18/2016 | 7/25/2021 | 98.31 | 2.11 | 3500 | 4968 | 3844 |
| DS0727 | 10/6/2016 | 7/25/2027 | 94.57 | 3.10 | 4000 | 5916 | 4359 |

| Fixed income market rates (closing mid-market levels) | | | | | | | | |
|---|----------|-----------|--------|--------|--------|--------|---------|--------|
| Date | 1Y WIBOR | 1Y T-bill | 2Y IRS | OK0715 | 5Y IRS | PS0718 | 10Y IRS | DS1023 |
| 11/18/2016 | 1.750 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 11/21/2016 | 1.750 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 11/22/2016 | 1.750 | 1.474 | 1.635 | 1.578 | 1.960 | 2.232 | 2.405 | 2.949 |
| 11/23/2016 | 1.750 | 1.474 | 1.635 | 1.638 | 1.990 | 2.290 | 2.447 | 2.985 |
| 11/24/2016 | 1.750 | 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 |
| 11/18/2016 | 7.60 | 7.25 | 7.70 | 7.90 | 7.90 | 2.38 | 0.64 |
| 11/21/2016 | 7.60 | 7.20 | 7.50 | 7.78 | 7.78 | 2.38 | 0.64 |
| 11/22/2016 | 7.58 | 7.14 | 7.63 | 7.65 | 7.65 | 2.49 | 0.69 |
| 11/23/2016 | 7.73 | 7.25 | 7.65 | 7.83 | 7.83 | 2.40 | 0.69 |
| 11/24/2016 | 7.50 | 7.45 | 7.68 | 7.85 | 7.85 | 2.47 | 0.67 |

| PLN Spot performance | | | | | | |
|----------------------|--------|--------|--------|--------|--------|--------|
| Date | EURPLN | USDPLN | CHFPLN | JPYPLN | HUFPLN | CZKPLN |
| 11/18/2016 | 4.4484 | 4.1968 | 4.1578 | 3.7925 | 1.4343 | 0.1646 |
| 11/21/2016 | 4.4390 | 4.1748 | 4.1345 | 3.7684 | 1.4357 | 0.1640 |
| 11/22/2016 | 4.4199 | 4.1507 | 4.1152 | 3.7487 | 1.4339 | 0.1633 |
| 11/23/2016 | 4.4131 | 4.1588 | 4.1111 | 3.7463 | 1.4282 | 0.1632 |
| 11/24/2016 | 4.4261 | 4.1880 | 4.1236 | 3.7115 | 1.4258 | 0.1637 |

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