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Polish Weekly Review

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Comment on the upcoming data and forecasts

Holiday season and New Year time are not empty of important publications from Polish economy. On December 30th the CSO will present flash CPI data for November, it is however too early to make specific predictions (we do expect it to accelerate markedly on the back of fuel prices). On the same data, the NBP will publish quarterly balance of payments data. New Year starts on Tuesday with Manufacturing PMI. Our final forecasts are still being tailored.

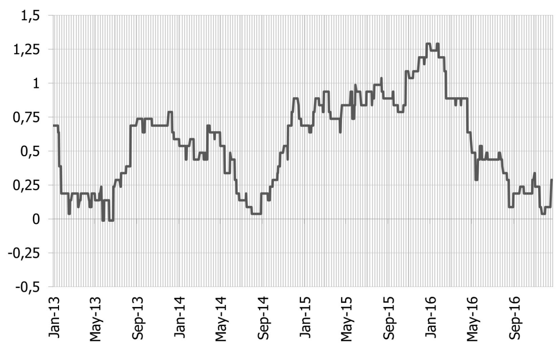
Polish data to watch: December 27th to January 5th

Publication	Date	Period	mBank	Consensus	Prior
CPI y/y (%) *flash*	30.12	Dec			0.0
Current account (mio EUR)	30.12	Q3			988
Exports (mio EUR)	30.12	Q3			44338
Imports (mio EUR)	30.12	Q3			42903
Manufacturing PMI (p.)	02.01	Dec			51.9

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	1.742	10/6/2016
5Y T-bond PS0722	-	4000	2.499	11/17/2016
10Y T-bond DS0727	-	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 had a terrific week after real sphere data (industrial production, retail sales and, most of all, PPI) were much better than market participants had expected. The turn of the year brings more opportunities to surprise, with flash CPI and Manufacturing PMI for December.

* 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

- 2016 unfolded as the year of record divergence between investment growth and consumption growth. The latter is the only engine of growth.
- GDP growth will likely bottom at 1.7-2.3% y/y in Q4, when base effects reach their peaks. Next year, growth will accelerate to the average of 3%, as investment returns to growth. It will, however, come no sooner than in mid-year and the effects of 500+ programme will begin to fade by then. The period of lower growth is not over.
- Polish deflation has ended. During the next two quarters inflation will be boosted by statistical base effects, weak PLN and commodity price spike (headline inflation to reach 1.5-2.0% at the turn of Q1 and Q2). We are skeptical of genuine inflationary pressures in the Polish economy, though.
- Rate cuts are still a possibility (but MPC is very unwilling to ease and global trend is for tightening).

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 more hawkish Fed hold in check any strengthening of Polish zloty.

mBank forecasts

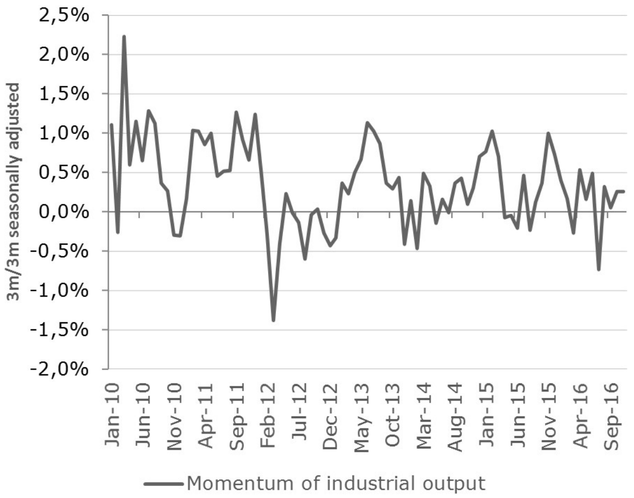
	2012	2013	2014	2015	2016 F	2017 F
GDP y/y (%)	1.6	1.4	3.3	3.9	2.5	3.0
CPI Inflation y/y (average %)	3.7	0.9	-0.1	-0.9	-0.6	1.3
Current account (%GDP)	-3.7	-1.3	-2.0	-0.1	-0.7	-0.9
Unemployment rate (end of period %)	13.4	13.4	11.4	9.8	8.3	8.1
Repo rate (end of period %)	4.25	2.50	2.00	1.50	1.50	1.25

	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	2.5	1.7	2.2	2.8	3.4	3.5
Individual consumption y/y (%)	3.2	3.3	3.9	4.6	4.3	4.0	3.8	3.5
Public Consumption y/y (%)	4.2	3.9	4.9	1.0	3.0	3.0	3.0	3.0
Investment y/y (%)	-2.2	-5.0	-7.7	-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	8.3	8.5	7.9	7.5	7.8
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

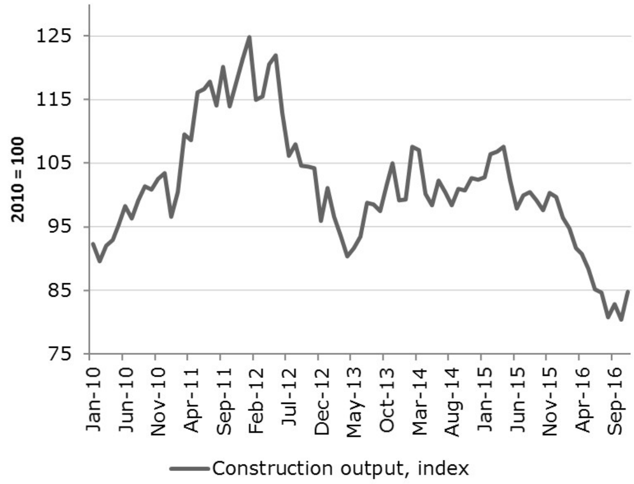
F - forecast

Industrial production and construction data mark a turning point in revision of GDP forecasts

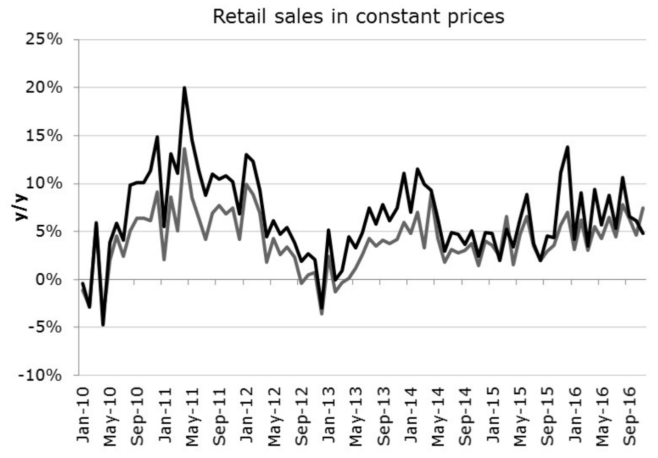
Industrial output grew by 3.3% y/y in November, beating market consensus and our own forecast (+1.5 and -0.3% r/r, respectively). This is an impressive result, given the strong base effects from last year. To briefly recap – industrial output in November '15 was boosted by spending ahead of the end of the previous EU programming period. We estimate this effect to amount to ca. 1-1.3 pp. It was, however, swamped by calendar (working day count ticked up from -1 to 0 y/y) and the general increase in demand in the majority of industries. A quick review of detailed data suggests that both export - and domestic - oriented industries rebounded in November. A clear culprit for the former is the strong sentiment in Eurozone manufacturing, the latter was likely boosted by the resurgence of construction and construction-related spending in Poland.



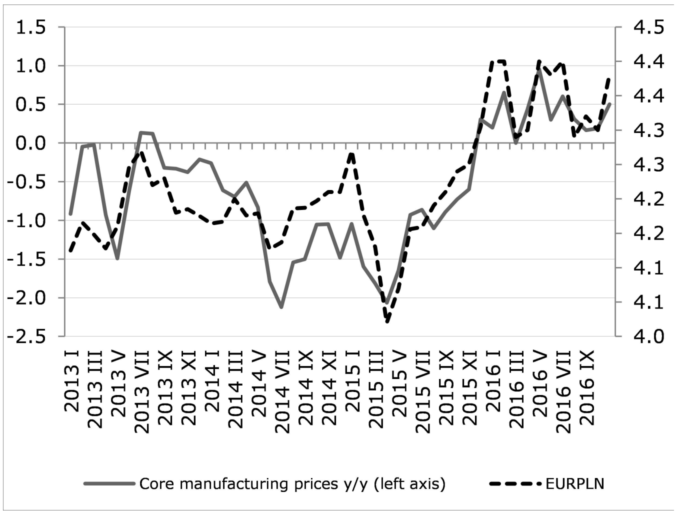
Construction output declined in November by 12.8% on a yearly basis, much less than our forecast and market consensus have indicated. On a monthly basis it grew by 6.7% (seasonally adjusted), which not only is a significant rebound after weak October (-3.0%) but also the highest monthly rise since February 2014. The reason for this surprise could be the on-going change in seasonal patterns – some projects are being completed or settled later than before, and we do not think that weather had significant impact. To see the details we need to wait for quarterly data (due in January). Today's data could be the first sign of a revival of investment. It is most probable that local governments' activity picked up earlier than expected (a notable example is the extension of second metro line in Warsaw).



Retail sales accelerated to 6.6% y/y in November. It paid off to expect mean (trend) reverting: auto sales reaccelerated, accompanied by food sales and "other" category; a spectacular 7.1% y/y growth in fuel sales was recorded and it was driven by real sales (demand). We think that households get slowly used to additional income flowing from social benefits and tighter labor market. Therefore, the fourth quarter may be marked by record high consumption growth for this year (it fits perfectly well with investment rebound, as pointed by construction data). Having said that, it is worth to stress that retail sales is propelled by income inelastic categories (food, fuels). As soon as base effects kick in and real income growth softens (H2 2017) retail sales should switch roles with investment activity as the GDP propeller. Even at this very moment core retail sales is moving more or less in a horizontal way.



Producer prices shot up to 1.7% y/y, beating consensus and our forecast. Although prices in manufacturing were in line with our forecast (+0.4% m/m), prices in mining really sky-rocketed (+17.8% m/m) on the basis of coal prices (coke-coal prices doubled m/m). Correlation between core manufacturing prices and exchange rate stays intact. We may see some acceleration there as well as coke and coal remains an important input for many manufacturing sections (hump-shaped reaction in the months ahead). This should reinforce the upward push generated by base effects.



We are revising our GDP forecast for the fourth quarter: even though we continue to see a slowdown relative to +2.5% y/y in the third quarter, the rebound in construction and positive spillovers to manufacturing point to a much better Q4 than we originally forecast. GDP likely grew by more than 2%, although error bars are wide due to uncertainty regarding public investment. In all likelihood, investment bottomed in Q3. From the MPC's perspective today's bundle of data is good news and a clear confirmation of their current strategy of waiting out the slowdown. We still see a rate cut as a risk but definitely not a baseline scenario. Even though our initial expectations regarding the depth and the length of the slowdown were correct, we underestimated the willingness of the MPC to see through current data. Finally, the MPC's focus continues to be on financial stability. The Council's view will be confirmed by the fast increase in inflation in the first months of 2017 (as confirmed by PPI data).

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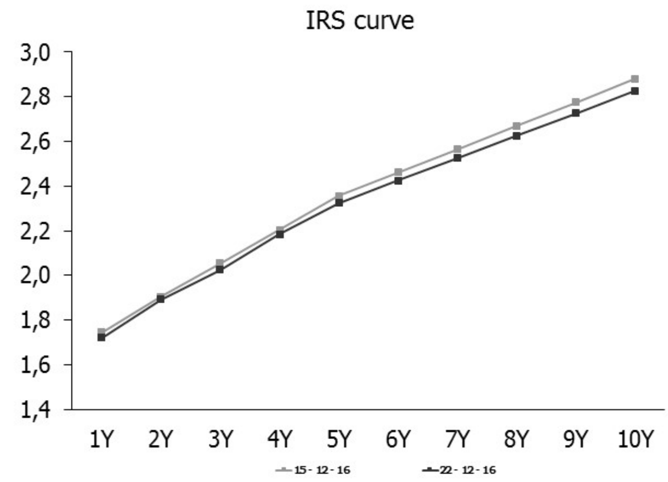
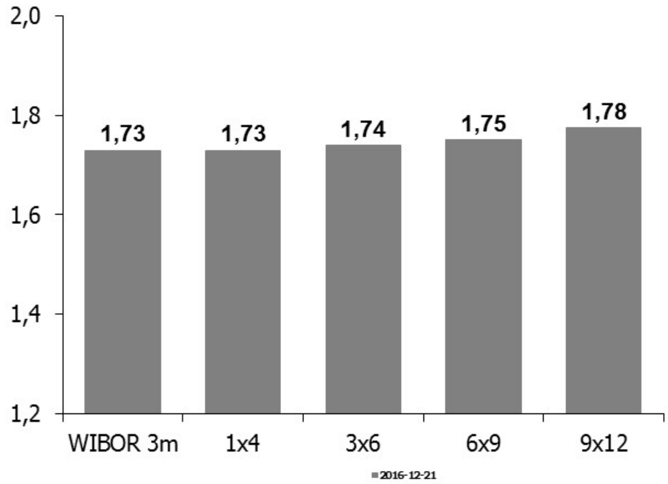
Fixed income

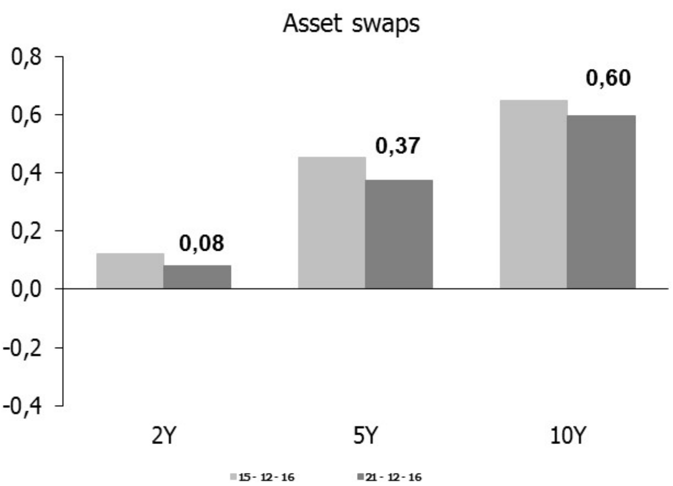
New auction policy

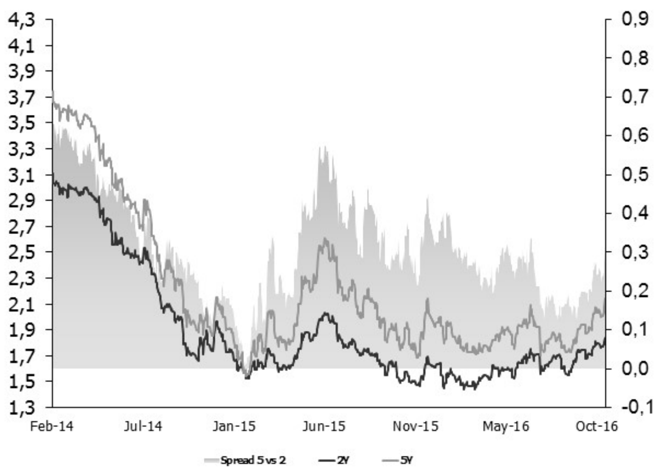
Today, the Ministry of Finance announced changes to the policy of Treasury bonds auctions. The new model starts on 4th of January – 5 bonds (OK, PS, DS, short-term and long term floaters) will be issued on every auction. Additionally, there could also be a sixth bond type, like WS or IZ.

Liquidity hasn't gone back to normal last week. DS0726 yield fell from 3.57% to 3.50%, PS0721 went down from 2.76 to 2.72% and OK1018 yield has frozen at 1.94%. The PS0721/DS0726 spread narrowed from 79 bps to 74 bps; DS0726/DS0727 traded at 7 bps. ASW PS0721/5y is trading at 34 bps and DS0726/10y at 57 bps now. Market looks really quiet and we suppose it will last until the end of the year.









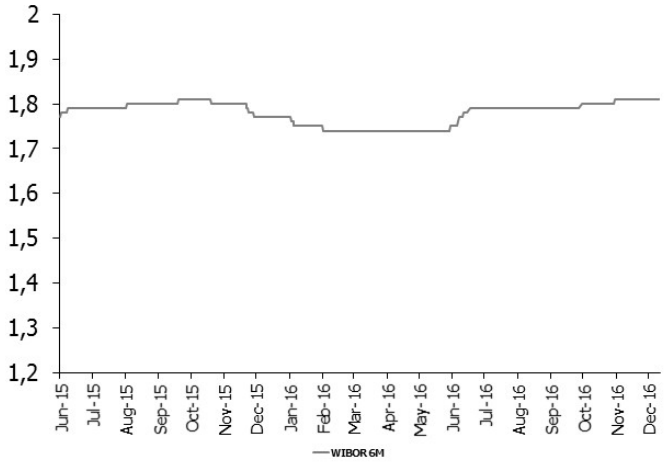
Money market

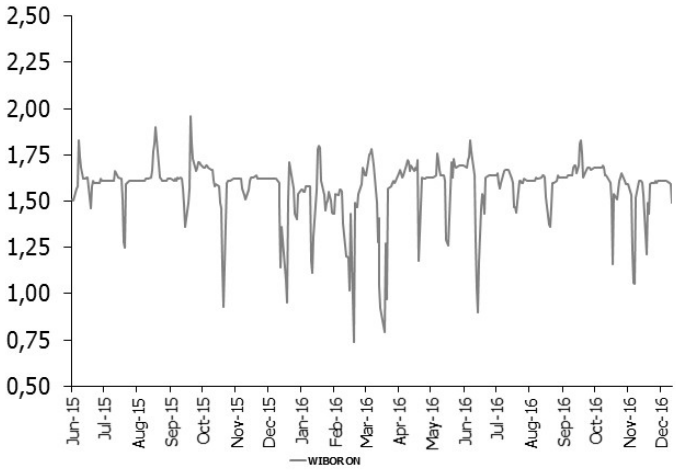
Stability before Christmas, changes from the New Year

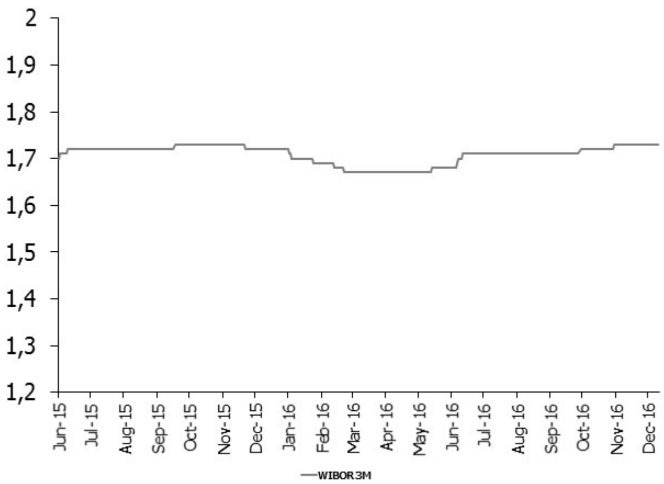
Market have settled down before Christmas. Banks have limited their activity and are focusing on closing down positions and securing liquidity over the year's end. Some market players are asking about shortest bond buyback announced few weeks ago by the Ministry, but it looks like it will be aborted. What's worth mentioning, is a new bond auction formula which will be implemented next year. In short, the ministry will offer every on-the-run bond on each auction. We will get 2, 5 and 10 year benchmarks with one short and one long floater at every tender.

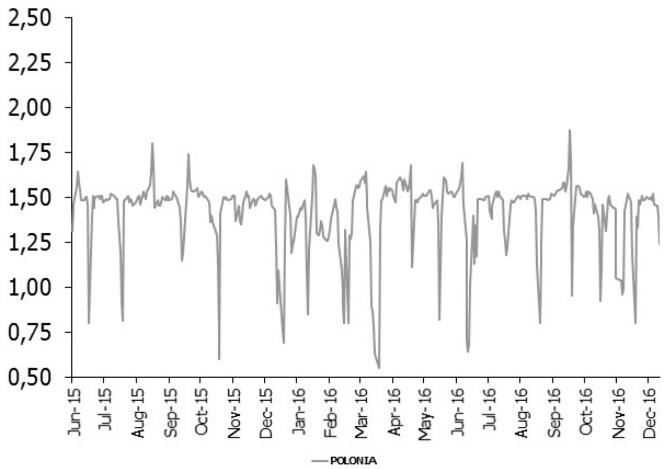
When it comes to overnight funding, it should be cheap until year end, but we repeat once again "don't bet on that, secure your liquidity and have a happy Christmas".

Ref rate vs Polonia averages: 30 day 9 bp 90 day 9 bp





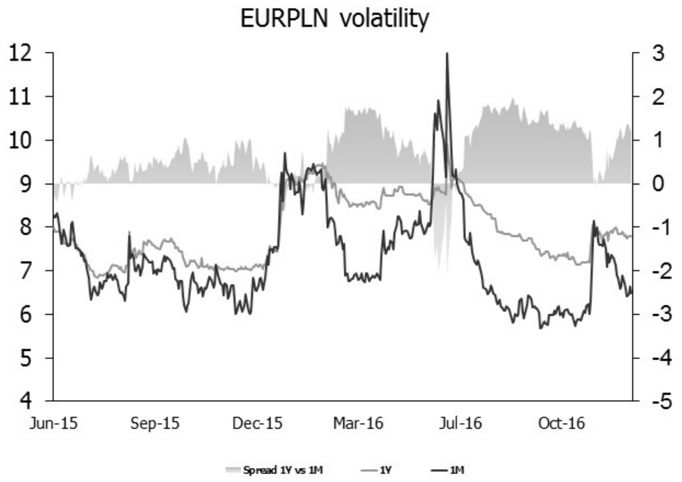




Forex

Spot – Consolidation It was another calm week for Zloty, which was supported by good Polish economic data and the incoming holiday period. Political stand-off in Poland seems to have been completely ignored. EUR/PLN was consolidating in a relatively tight range (4.4030-4.4340), same for USD/PLN (trading range 4.2150-4.230). In general, we think that PLN and the rest of EM currencies may have only limited appreciation perspectives, because of hawkish FOMC. We define current range as 4.40-4.50, and we will be bit more skewed to buy dips rather than sell spikes.

Options – EUR/PLN vols consolidating The EUR/PLN volatility curve is virtually unchanged with frontend still slightly better offered. 1 month EUR/PLN ATM mid is at 6.3%, 3 months EUR/PLN at 7.1% and, finally, 1 year is fixing at 7.75%. The currency spread (difference between USD/PLN and EUR/PLN) was finally better offered after weeks of growth. On Thursday, 6 months USDPLN ATM was traded at 14.25% in impressive notional. Skew is roughly unchanged.



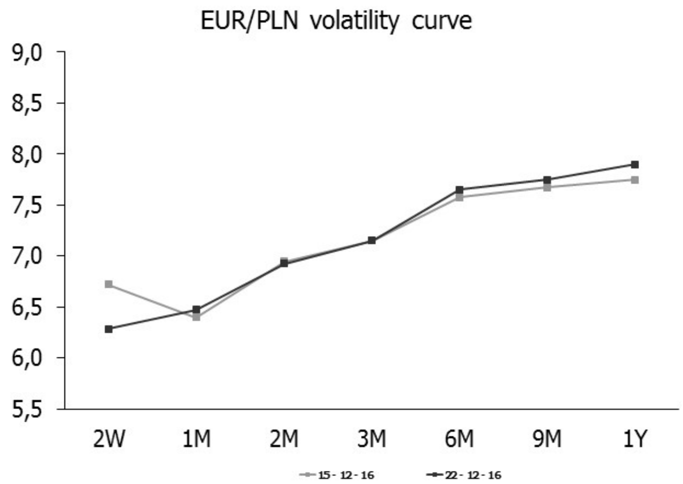
Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.40 / 4.50
USD/PLN: 4.00 / 4.30

Spot Position: Long EUR/PLN.

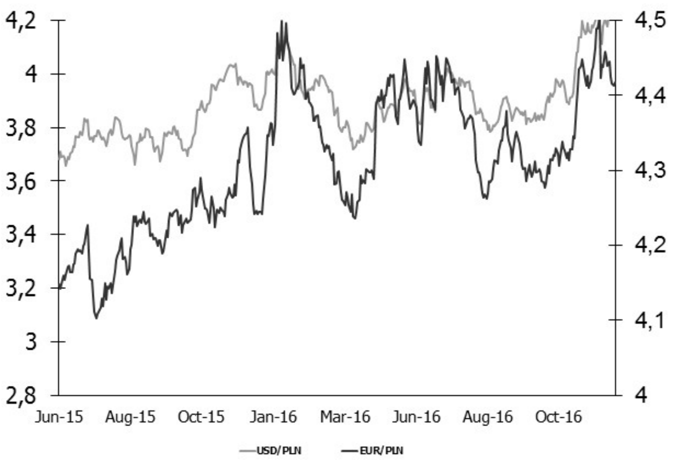
We are long EUR/PLN at 4.4400 and we are ready to add at 4.3950 with stop at 4.37 and hopes to see a break of this year's high of 4.5390.

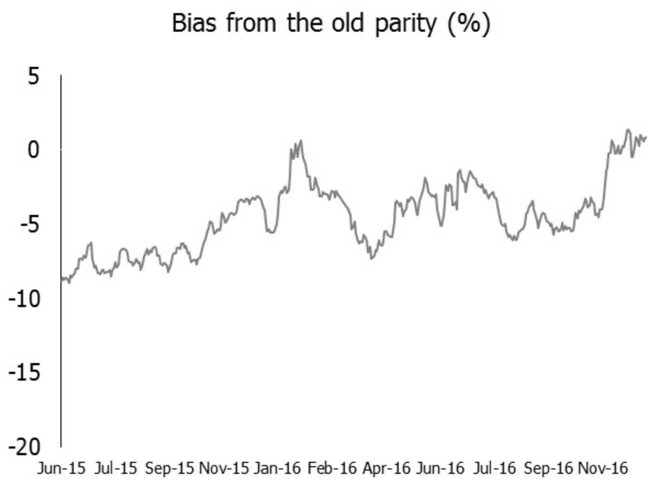
Hawkish FOMC is a supportive factor for weaker PLN. We expect 4.37-4.40 support zone to hold, but shallow liquidity around Christmas may produce choppy price action. One needs to keep some flexibility, and leave room to add on unexpected Zloty strength.



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 limit. With fast approaching Christmas, we prefer to keep light positions. We would be buyers of backend if it revisits this year's lows, or sellers of the frontend if some panic/risk off hits the market.





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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
12/15/2016	2.16	1.73	2.16	1.71	2.21	1.75	1.73	1.74	1.75	1.78	1.84	1.85
12/18/2016	1.78	1.73	2.10	1.71	1.89	1.75	1.73	1.74	1.76	1.78	1.83	1.85
12/19/2016	2.23	1.73	2.21	1.71	2.23	1.75	1.73	1.73	1.75	1.78	1.83	1.85
12/20/2016	1.54	1.73	1.61	1.71	1.65	1.75	1.73	1.73	1.75	1.78	1.83	1.85
12/21/2016	1.78	1.73	2.08	1.71	2.18	1.75	1.73	1.74	1.75	1.78	1.83	1.85

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
12/15/2016	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
12/18/2016	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
12/19/2016	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
12/20/2016	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
12/21/2016	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
12/15/2016	6.40	7.15	7.58	7.75	7.75	2.21	0.70
12/18/2016	6.45	7.15	7.60	7.80	7.80	2.21	0.70
12/19/2016	6.63	7.20	7.58	7.80	7.80	2.10	0.61
12/20/2016	6.48	7.10	7.55	7.80	7.80	2.21	0.61
12/21/2016	6.48	7.15	7.65	7.90	7.90	1.91	0.70

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
12/15/2016	4.4453	4.2329	4.1334	3.5909	1.4168	0.1645
12/18/2016	4.4253	4.2296	4.1152	3.5828	1.4164	0.1638
12/19/2016	4.4157	4.2255	4.1185	3.5967	1.4152	0.1633
12/20/2016	4.4128	4.2493	4.1289	3.5992	1.4177	0.1632
12/21/2016	4.4180	4.2484	4.1357	3.6139	1.4234	0.1635

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