June 29, 2017

Polish Weekly Review

mBank Research
(macro/FI/FX analysis)

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Table of contents

Comment on the upcoming data and forecasts

This Friday, flash CPI reading for June will be published. We forecast that CPI inflation fell to 1.8% from 1.9% y/y in May, owing to a drop in fuel prices coupled with a monthly rise of food prices (oils and fats, meat). Polish manufacturing PMI for June will be published on Monday. Last month's drop will be erased with a jump to 53.4 – we already know that economic sentiment, as seen in CSO's business confidence indicators, improved. On Wednesday, the MPC will conclude its two-day meeting, but we do not expect any changes in interest rates. The Council's members will acquaint themselves with the latest GDP and CPI forecasts from NBP's economists (we think that projections of both GDP and CPI might be upgraded, the former because of higher starting point and stronger consumption, the latter due to faster core inflation). The positive scenario for the Polish economy assumed by the MPC appears to be coming true, so the general mood during the conference will once again be optimistic. Inflation gently fluctuating within the target band will also be helpful here.

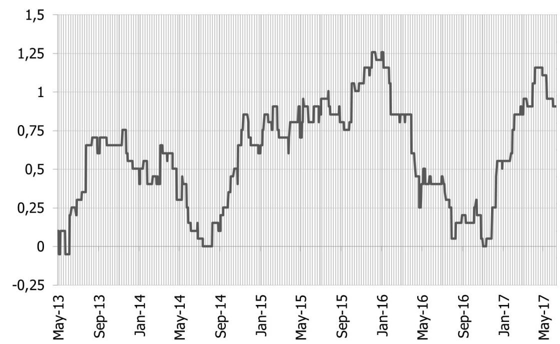
Polish data to watch: June 30th to July 7th

Publication	Date	Period	mBank	Consensus	Prior
CPI y/y (%) *flash*	30.06	Jun	1.8	1.7	1.9
Manufacturing PMI (p.)	03.07	Jun	53.4	53.4	52.7
MPC decision (%)	05.07	Jul	1.5	1.5	1.5

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
(29–37/52) Week T-bills	-	700	1.500	2/22/2017
2Y T-bond OK1019	7/6/2017	600	1.859	6/9/2017
5Y T-bond PS0422	7/6/2017	1000	2.587	6/9/2017
10Y T-bond DS0727	7/6/2017	600	3.128	6/9/2017
30Y T-bond WS0447	-	100	3.508	6/9/2017

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



Comment

Unchanged, since unemployment rate came in line with market consensus. In the next few days we have two opportunities to move the index: flash CPI this Friday and manufacturing PMI on Monday.

* 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

- Q1 GDP figures (4.0% y/y) confirmed that the economy is operating on a high gear. However, so far there is little to suggest that it would continue to accelerate. Household consumption will ultimately slow down slightly, as base effects and inflation bite, while the looming acceleration in investment is set to be checked by negative net exports. Therefore, we are comfortable with our current forecast of flat GDP growth path throughout the year. Rapid acceleration in wages or swifter return of private investment are clear, upside risks for growth this year.
- Boosted by statistical base effects, weak PLN, food price hikes and commodity price spike, headline inflation breached 2% and will fluctuate within the target band. The effects of higher domestic seasonal food prices and lower fuel prices will likely cancel each other out. Thus, inflation forecast for 2017 is mostly unchanged so far.
- However, the case for accelerating core inflation is strengthening. Stellar employment performance shows no respite but wage growth remains moderate. Such equilibrium is unsustainable. If 2007 and 2008 are taken as guide, wages are ready to take off this year as current demand for labor meets limited supply.
- MPC stays calm and waits rises in headline inflation out, while carrying steady message of stable rates. Such rhetoric can stay in place for some months. However, as trend in core inflation emerges as evident and labor market strengthen further, the case for rate hikes is set to strengthen as well. All we need is a small change in MPC's wording to make rate expectations wander somewhat more freely.
- Solid labor market performance and prospect for faster growing wages support PIT and VAT revenue from consumption. With much higher headline inflation already in place (deflationary 2016!), further improvements in tax income seem a safe bet for 2017 even without any stringent assumptions on the efficiency of tax collection.

Financial markets

- Zloty benefited in lower rates environment among renewed EM inflows. Substantial improvement in fiscal position seems to be the most important factor for investors (compression of credit risks).
- Stronger GDP growth should underpin the zloty in the mid-term as it stays undervalued in real effective (REER) terms.
- Having said that, there is a constant risk of upward corrections driven either by the repricing of global risk-free rates, or bursts of risk aversion stemming from non-economic news. Heavy positioning (long PLN is clearly a crowded trade) is both a blessing and curse here.

mBank forecasts

	2013	2014	2015	2016	2017 F	2018 F
GDP y/y (%)	1.4	3.3	3.8	2.7	4.0	4.0
CPI Inflation y/y (average %)	0.9	-0.1	-0.9	-0.6	2.0	2.3
Current account (%GDP)	-1.2	-2.1	-0.6	-0.6	-0.9	-1.1
Unemployment rate (end of period %)	13.4	11.4	9.8	8.3	6.7	6.0
Repo rate (end of period %)	2.50	2.00	1.50	1.50	1.50	2.25

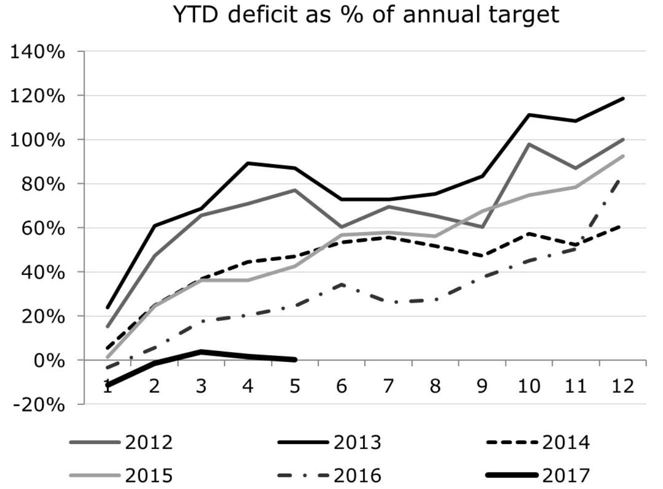
	2017 Q1	2017 Q2 F	2017 Q3 F	2017 Q4 F	2018 Q1 F	2018 Q2 F	2018 Q3 F	2018 Q4 F
GDP y/y (%)	4.0	3.8	4.0	4.3	3.8	4.0	4.0	4.0
Individual consumption y/y (%)	4.7	4.5	4.2	4.0	4.0	3.8	3.8	3.8
Public Consumption y/y (%)	1.0	2.0	2.5	3.0	4.0	3.0	3.0	3.0
Investment y/y (%)	-0.4	4.5	7.0	12.0	12.0	11.0	8.0	7.0
Inflation rate (% average)	2.0	1.9	2.1	2.1	2.1	2.2	2.3	2.4
Unemployment rate (% eop)	8.2	7.0	6.5	6.7	6.9	5.9	5.7	6.0
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.25
Wibor 3M (% eop)	1.73	1.73	1.73	1.73	1.73	1.98	2.23	2.48
2Y Polish bond yields (% eop)	2.01	2.00	2.09	2.22	2.41	2.66	2.84	2.97
10Y Polish bond yields (% eop)	3.49	3.25	3.37	3.53	3.75	4.03	4.24	4.40
EUR/PLN (eop)	4.23	4.20	4.15	4.10	4.10	4.10	4.08	4.05
USD/PLN (eop)	3.97	3.75	3.77	3.80	3.80	3.73	3.64	3.55

F - forecast

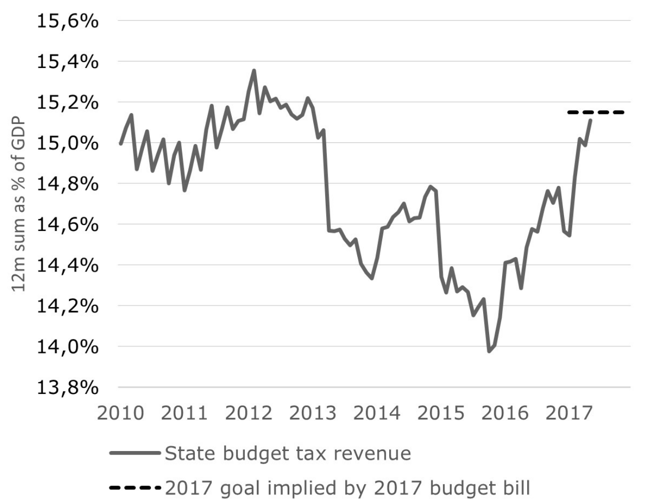
Economics

Historically low budget deficit

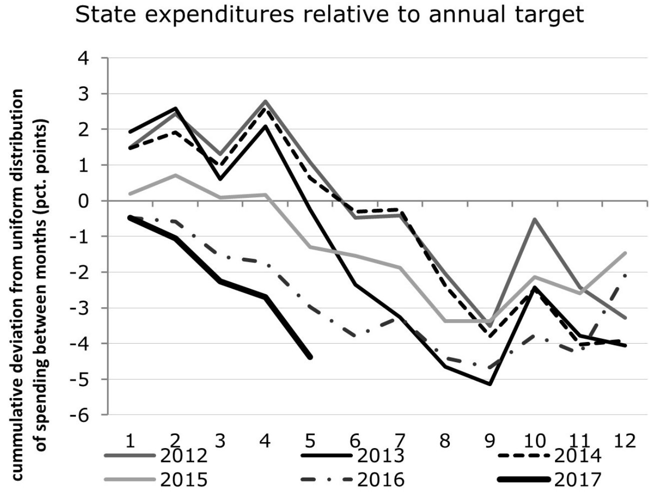
Poland's state budget deficit amounted to a mere 200 mio PLN after May. To put that into context, cumulative deficit in the first 5 months of the year averaged 10-20 bn PLN in the post-crisis period.



Just as in every month of 2017, tax revenues performed strongly, having grown by 11% in May alone. Growth in tax revenues was driven by all major categories: VAT +13%, CIT +9%, PIT +7%, excise taxes +5% y/y. The trends here are so far very steep and unbroken (see the graph below). According to our estimates, tax revenue (calculated on a 12m rolling basis) exceeded 15% of GDP in the first quarter already and remains on track to reach its 2017 target (15.1-15.2% of GDP on average), thereby exceeding our initial projections of a modest shortfall. Reasons for this deserve a separate analysis, therefore for the time being we will just enumerate them: strong labor market performance, rebound in nominal GDP, favorable GDP structure (driven almost exclusively dependent on tax-generating consumption), the crackdown on tax avoidance and higher credibility of tax administration. Finally, one should note the campaign to boost tax collections has not ended and can be expected to provide more revenue in the future.



In addition, the exceptionally low fiscal deficit can be traced to the big slowdown in spending. Compared to the revenue side, the restraint in expenditures received little media attention – unjustifiably so. We believe that this development (see the graph below) can be attributed to low debt service costs and significant decline in subsidies to social security funds – a result of crackdown on civil law contracts and faster wage growth in recent months.



The record-high payment of NBP profit (in June or July) will keep the state budget close to balance for two more months. This, along with current trends in tax revenues and expenditures, suggests that the state budget deficit will fall below 30 bn PLN this year, half of the approved deficit. Actual year-end performance will, however, depend on whether the Ministry of Finance decides to shift some revenues and expenditures between 2017 and 2018. We think that this opportunity will be exploited, the more so since 2018 budget does not look as rosy as this year's. Likely absence of NBP profit is one example, but the need to bear the full costs of lowering the statutory retirement age is a second factor in this. The third reason to consider 2018 a challenging fiscal year is the need to finance public investment (EU-funded). So far, these considerations have not yet had an impact on the markets: at best it allows risk premia to remain tight, while global factors are pushing bond yields higher.

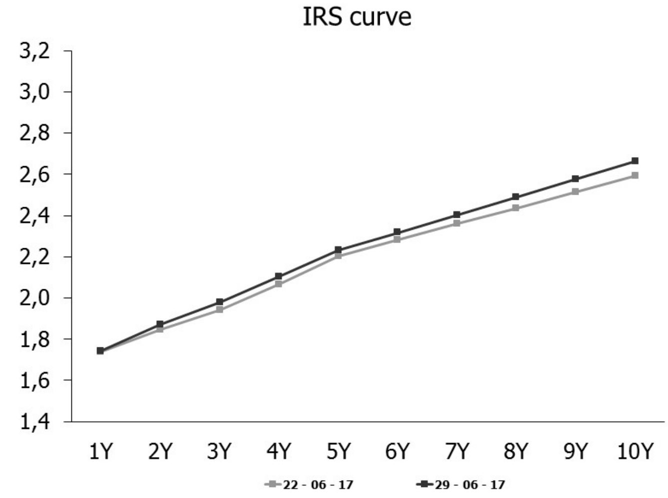
Fixed income

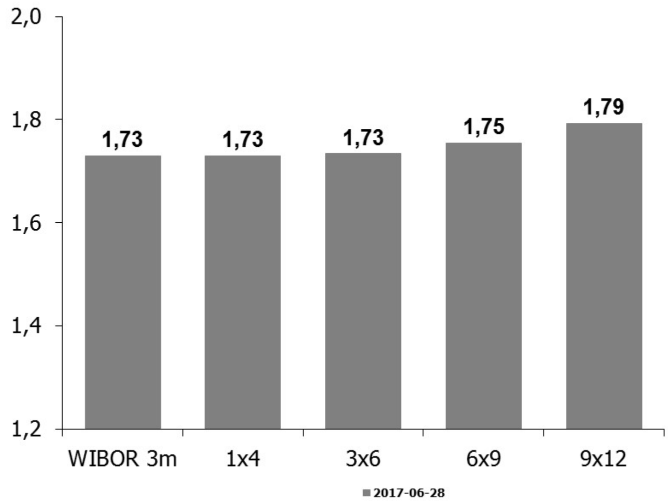
How many auctions will the MoF announce for Q3?

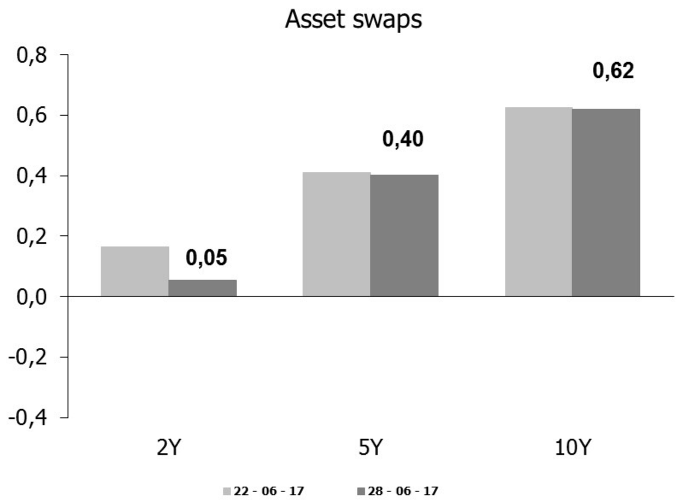
On Friday, the Ministry of Finance will announce auction schedule for Q3. We expect one in July, one switching auction in August and two in September. Also, on the first auction we will see a new 5y benchmark, PS0123. Coupon is unknown at this moment.

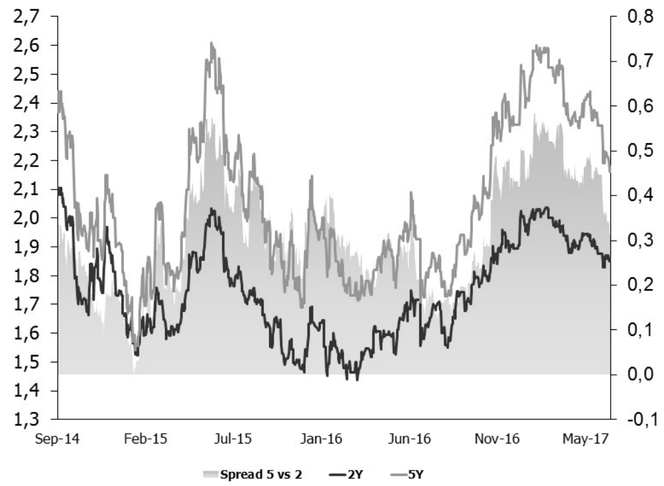
Bund/DS0727 spread is 289 bps today, the low was 281 bps. The PS0422/DS0727 is 65 bps, as curve is steepening. ASW PS0422/5y is at 34 bps and DS0727/10y is at 54 bps. OK0419 is trading at 1.83% (4bps down), PS0422 is trading at 2.68% (7 bps up) and DS0727 is trading at 3.34% (13 bps up).

In the last few days we had high volatility on the market. Curve has steepened and market looks heavy.







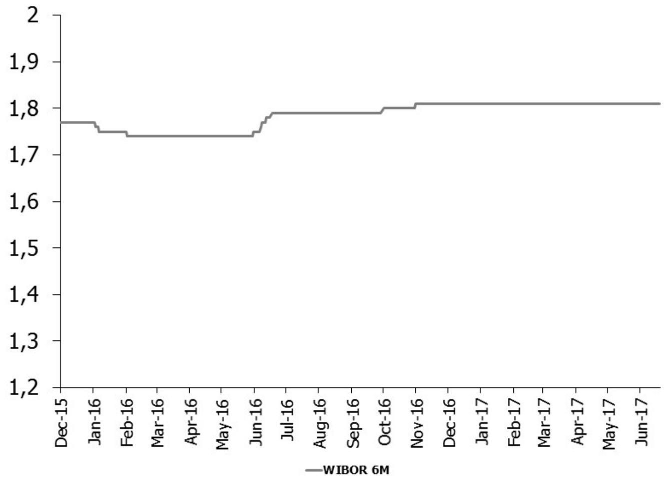


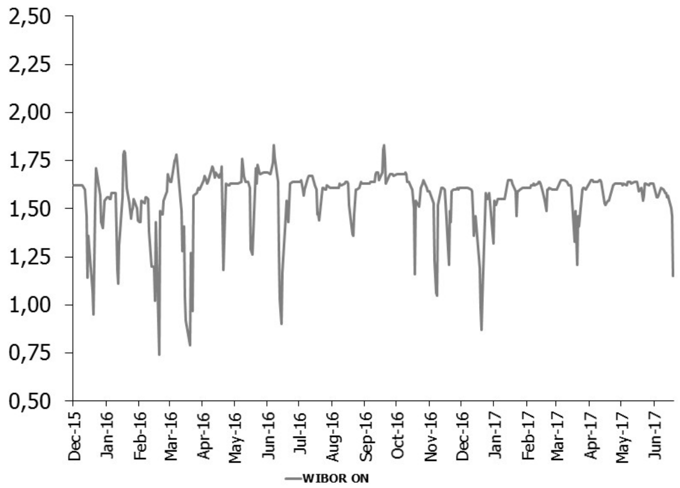
Money market

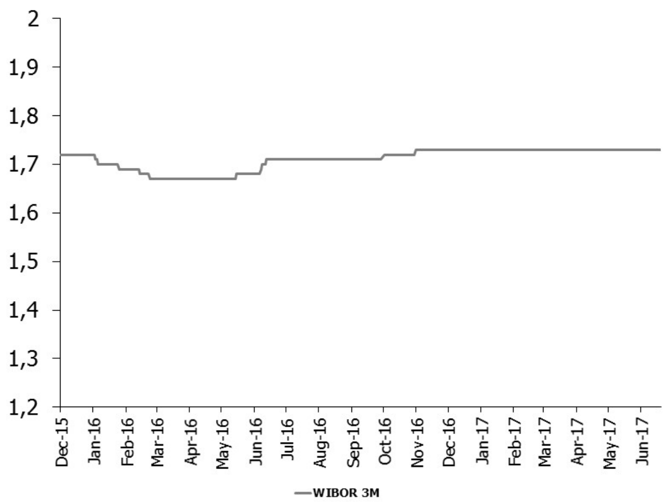
The trend has fallen

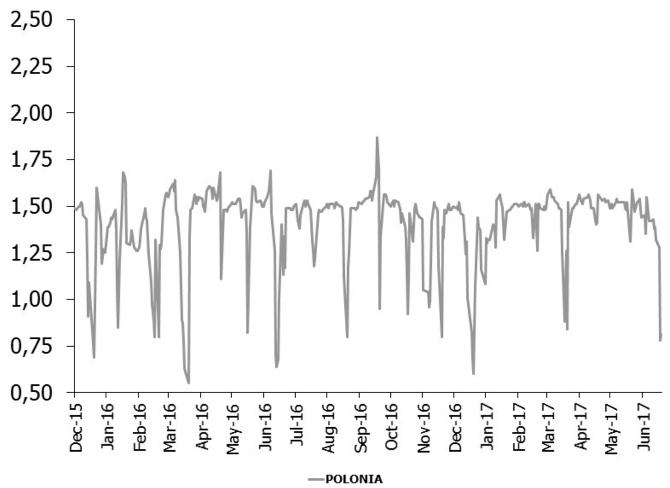
After a few months of rally on bonds we are breaking the trend. The trigger came from core markets. Fed hiked rates, BOE gave hawkish comments and this week Mr Draghi turned out less dovish than he used to be. Bulls are in defence and we are now in a tightening/reflation regime.

Ref rate vs Polonia averages:
30 day 10 bp
90 day 3 bp





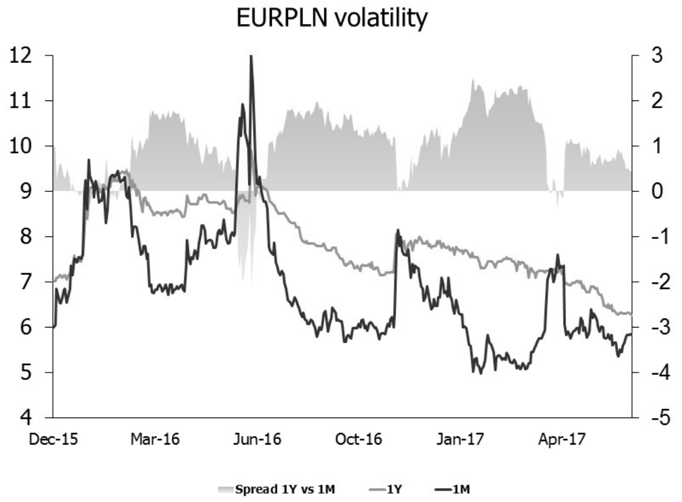




Forex

Spot – PLN – boxed in range. EUR/PLN was meandering between 4.2020 and 4.2480 since last Thursday. The turnover was rising with customers/flows on both sides of the market, thus we had moments of decent volatility as a result. We hope that the momentum, which could finally produce the healthy break out of the current 4.20-4.25 range, will built itself up. Given the news about Draghi and our preference, we see slightly better chance for a break-out to the upside.

EUR/PLN vols – tic higher in the front end EUR/USD spot move as well as a sequential move in vols were behind the upward shift in EUR/PLN and, in an even bigger scale, USD/PLN vol curves. 1 month EUR/PLN ATM is at 6.1% (0.25% higher), 3 months EUR/PLN is at 6.1% (0.25% higher) and, finally, 1 year is fixing at 6.50% (0.1% higher). The currency spread (difference between USD/PLN and EUR/PLN) shot higher by roughly 1% and the skew is roughly the same.



Short-term forecasts

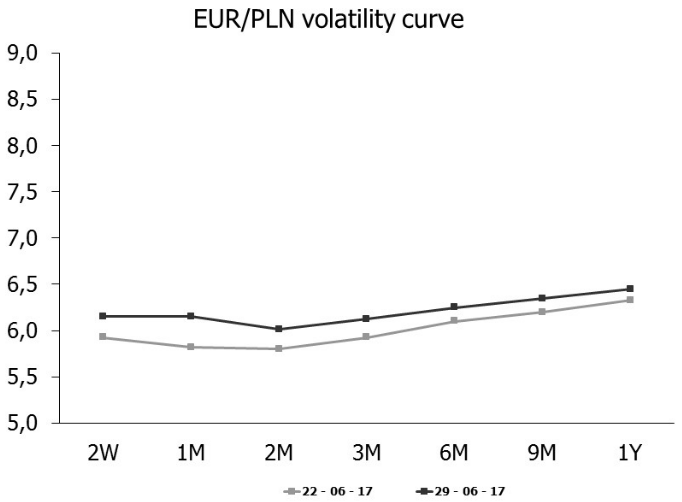
Main supports / resistances:
EUR/PLN: 4.20 / 4.30
USD/PLN: 3.70 / 4.00

Spot Current position: Long EUR/PLN at 4.2150.

We have reestablished our long at 4.2150, we are ready to add at 4,1850 with 4,1600 stop, hope to see 4.26+ and, eventually, 4.30. We have decided to put our toe again in the water, the logic is unchanged: dovish MPC, and historically attractive entry level.

Options Vol – long 3 month and 9 month EUR/PLN.

Our long positions in Vega (3 and 9 month) received some support from weaker PLN. The higher realized volatility makes Theta bills less painful. We still stick to the plan to reducing/liquidating that position before summer vacation begins. All we need is higher vol.



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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
6/22/2017	1.65	1.73	1.81	1.71	2.01	1.75	1.73	1.74	1.75	1.78	1.82	1.82
6/25/2017	1.65	1.73	1.81	1.71	2.00	1.75	1.73	1.74	1.75	1.80	1.83	1.83
6/26/2017	1.63	1.73	1.68	1.71	1.73	1.75	1.73	1.73	1.75	1.78	1.82	1.82
6/27/2017	1.56	1.73	1.72	1.71	1.91	1.75	1.73	1.74	1.77	1.81	1.85	1.84
6/28/2017	1.71	1.73	1.87	1.71	2.07	1.75	1.73	1.73	1.75	1.79	1.85	1.83

Last primary market rates

Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
32W TB	2/22/2017	8/30/2017	99.21	1.50	700	1832	726
OK0419	6/9/2017	4/25/2019	96.62	1.86	600	1505	500
PS0422	6/9/2017	4/25/2022	98.47	2.59	1000	1811	1085
DS0727	6/9/2017	7/25/2027	94.61	3.13	600	944	640

Fixed income market rates (closing mid-market levels)

Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
6/22/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/25/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/26/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
6/27/2017	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
6/28/2017	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
6/22/2017	5.83	5.93	6.10	6.33	6.33	1.86	0.55
6/25/2017	5.83	5.93	6.10	6.33	6.33	1.86	0.55
6/26/2017	5.85	5.91	6.04	6.30	6.30	1.81	0.58
6/27/2017	5.83	5.96	6.10	6.26	6.26	1.79	0.55
6/28/2017	6.15	6.13	6.25	6.45	6.45	1.78	0.55

PLN Spot performance

Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/22/2017	4.2442	3.8002	3.9050	3.4215	1.3729	0.1616
6/25/2017	4.2255	3.7824	3.8977	3.4014	1.3666	0.1608
6/26/2017	4.2117	3.7653	3.8773	3.3727	1.3616	0.1604
6/27/2017	4.2120	3.7442	3.8719	3.3551	1.3624	0.1603
6/28/2017	4.2317	3.7249	3.8782	3.3271	1.3655	0.1610

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