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Polish Weekly Review

mBank Research
(macro/FI/FX analysis)

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Comment on the upcoming data and forecasts

On Monday, the CSO will release flash CPI for July. We expect a rebound after the local low recorded in June (1.5% y/y), however, our final forecast still needs to be polished. On the next day, Polish manufacturing PMI will be published. Our forecast indicated a moderate rise, to 53.6 from 53.1 in June, which is consistent both with improvement in business outlook in CSO's surveys, and with sky-high sentiment in the euro area. In August, as always, there is no MPC meeting.

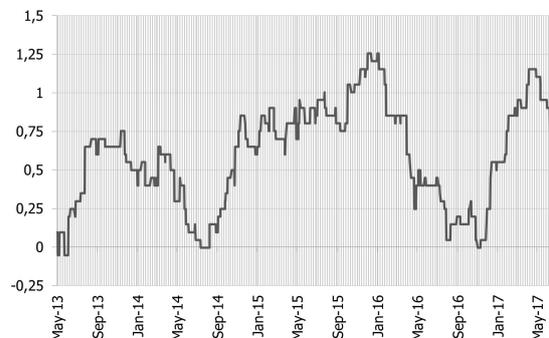
Polish data to watch: July 28th to August 4th

Publication	Date	Period	mBank	Consensus	Prior
CPI y/y (%) <i>flash</i>	31.07	Jul		1.6	1.5
Manufacturing PMI (p.)	01.08	Jul	53.6	53.2	53.1

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	8/3/2017	600	1.859	6/9/2017
5Y T-bond PS0422	8/3/2017	1000	2.587	6/9/2017
10Y T-bond DS0727	8/3/2017	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 from previous week after unemployment rate reading matched the original forecasts (and a tad below preliminary data published by the Ministry of Family, Labor and Social Policy). Next week brings two opportunities to move the index: flash CPI on Monday and manufacturing PMI the day after.

* 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

- 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.
- Lower fuel and food prices dragged inflation to the lower bound of the target band. We see it as the local minimum, though.
- 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 rate environment among renewed EM inflows. A bit more complicated local politics may have upped the demanded risk premium for a while (PLN rallies would find resistance higher in EURPLN terms).
- Stronger GDP growth should underpin the zloty in the mid-term as it stays undervalued in real effective (REER) terms.

mBank forecasts

	2013	2014	2015	2016	2017 F	2018 F
GDP y/y (%)	1.4	3.3	3.8	2.7	3.9	4.1
CPI Inflation y/y (average %)	0.9	-0.1	-0.9	-0.6	1.9	2.2
Current account (%GDP)	-1.2	-2.1	-0.6	-0.2	-0.9	-1.1
Unemployment rate (end of period %)	13.4	11.4	9.8	8.3	6.8	6.0
Repo rate (end of period %)	2.50	2.00	1.50	1.50	1.50	2.00

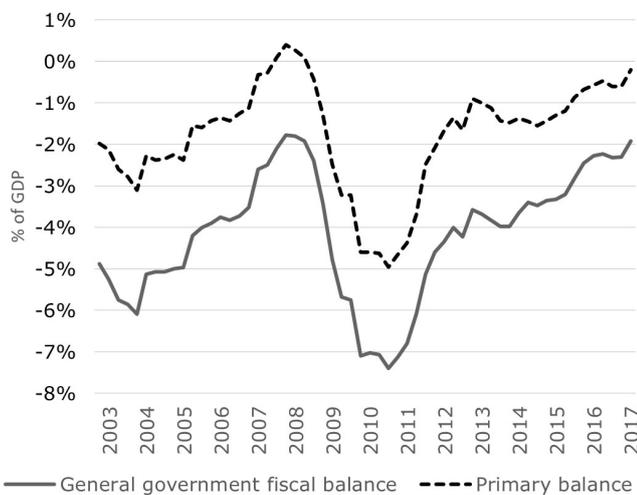
	2017	2017	2017	2017	2018	2018	2018	2018
	Q1	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F
GDP y/y (%)	4.0	3.8	3.8	3.9	4.0	4.0	4.2	4.2
Individual consumption y/y (%)	4.7	4.6	4.2	4.0	4.0	3.8	3.8	3.8
Public Consumption y/y (%)	1.0	2.0	2.5	3.0	4.0	3.0	3.0	3.0
Investment y/y (%)	-0.4	3.8	7.0	10.0	10.0	10.0	10.0	9.0
Inflation rate (% average)	2.0	1.8	1.7	1.9	1.5	2.2	2.6	2.6
Unemployment rate (% eop)	8.2	7.1	6.6	6.8	6.8	6.0	5.7	6.0
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00
Wibor 3M (% eop)	1.73	1.73	1.73	1.73	1.73	1.73	1.98	2.23
2Y Polish bond yields (% eop)	2.01	1.90	1.93	2.04	2.12	2.31	2.66	2.84
10Y Polish bond yields (% eop)	3.49	3.32	3.38	3.53	3.63	3.85	4.23	4.45
EUR/PLN (eop)	4.23	4.23	4.15	4.10	4.10	4.10	4.08	4.05
USD/PLN (eop)	3.97	3.70	3.67	3.63	3.63	3.60	3.55	3.49

F - forecast

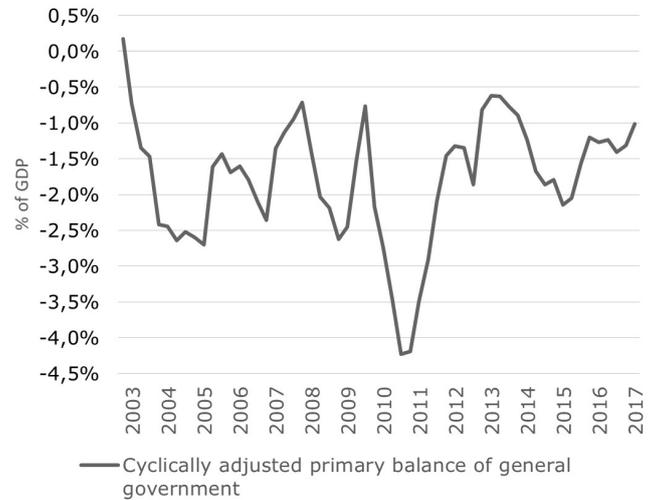
Economics

Putting Poland's stellar fiscal data in a broader context

There's no question that Poland's budget situation is very good. According to preliminary data, the state budget posted a 5.9 bn PLN surplus in the first half of the year – without a doubt the best ytd result in modern history. As we repeatedly indicated, multiple factors contribute to such stellar fiscal data: record-high NBP profit, favorable business cycle phase, consumption-heavy structure of GDP growth, tax reforms and the on-going crack-down on tax evasion. It would be a mistake to attribute fiscal figures to any single factor and it is also worth considering how Poland's public finances have evolved recently.



we showed previously); 2) modest, but steady improvement since 2015; 3) fiscal consolidation since 2015 is smaller than suggested by headline and primary deficit, it is nevertheless real.



First, the fiscal deficit of the entire government has declined materially – it averaged 1.9% GDP over the last four quarters, in no small part owing to the on-going retrenchment in local government spending (including investment). Second, even though interest payments have declined along with bond coupon rates, primary deficit is also close to all time high. Poland has not been that close to posting a primary surplus since 2008 (see the graph above). Third, business cycle has likely helped a lot to achieve this result. General government deficit is obviously cyclical itself, as even a cursory examination of the data would reveal. Because of this, calculating cyclically adjusted fiscal variables (like CAPB – cyclically adjusted primary balance) has become a standard procedure in public finance analysis. Unfortunately, the vast majority of methods are as good and precise as the estimates of potential GDP used as input variables.

To simplify matters, we opted for a simple approach. Using industrial capacity utilization as a proxy for out gap, we filtered the cyclical component from primary balance series and then adjusted the residuals so that their average matched the average unadjusted primary balance in the 2003-2017 period. That way, the overall adjustment is neutral for the total fiscal stance over the above mentioned period. The downside of this adjustment is that ignores changes in taxation and different elasticities of different tax revenue classes (certainly, we hope to refine this method in the future). Several conclusions can be drawn from this exercise: 1) deterioration of fiscal stance in the 2013-2014 period (corroborated by tax revenue / GDP ratio

Fixed income

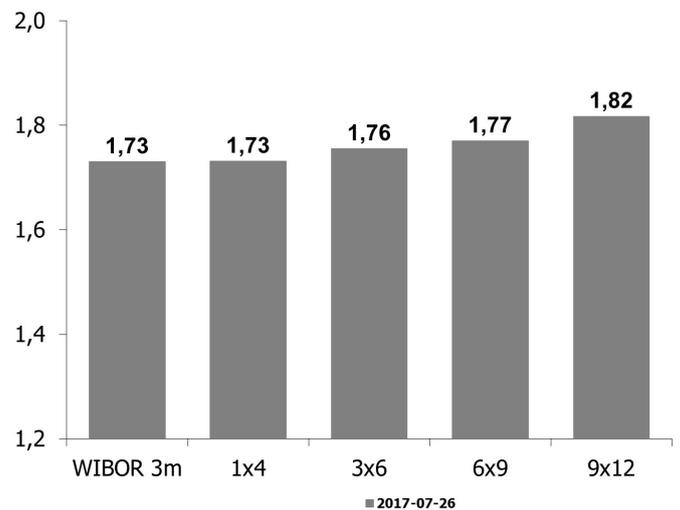
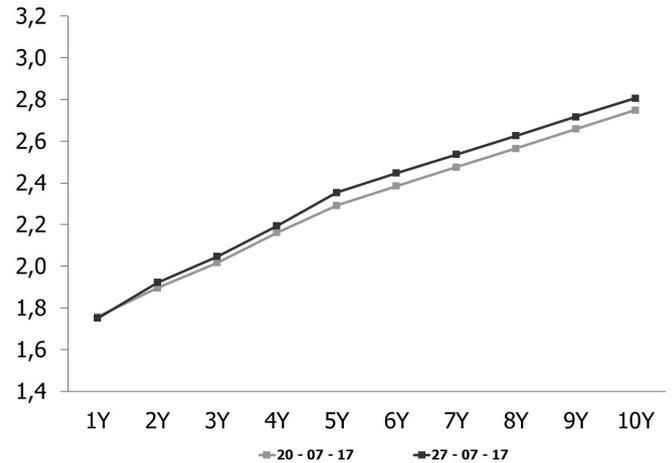
T-bond auctions coming back in August

Ministry of Finance will soon announce T-bond auctions calendar on August. As far as we know, there will be one switching auction with the 2y benchmark (OK0419), a new 5y bond, PS0123, with 2.50% coupon, 10y benchmark, DS0727, and two floaters.

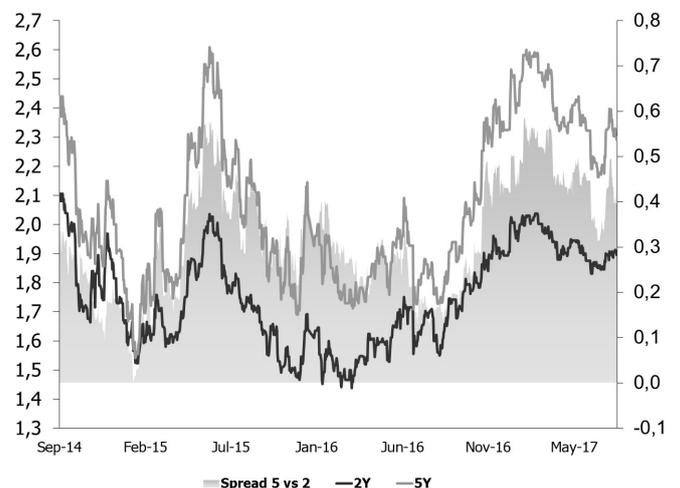
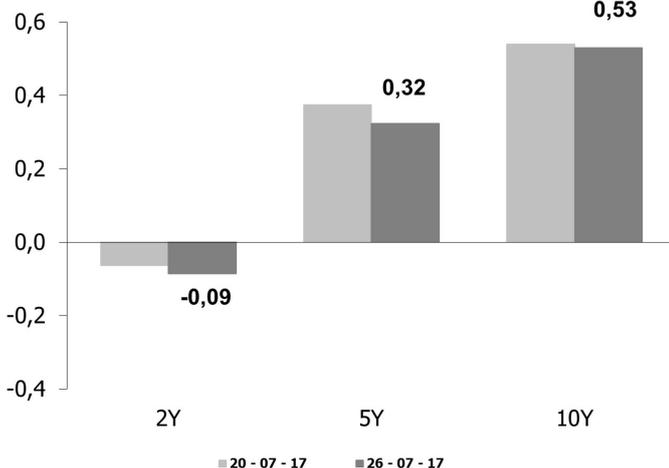
For 2 weeks, Polish market was moving in a narrow 50 bps range, mostly following core markets. Maturing OK0717 mostly went to short-end bonds and floaters, just as we thought. Current political situation in Poland looks better, but we still see potential risk on ASW. PS0422/5y is trading at 27 bps and DS0727/10y at 47 bps. On Wednesday, the Fed said balance sheet unwind would begin relatively soon, with 40% probability of a hike in December. The decision to taper will be discussed by the ECB on September.

2y benchmark, OK0419, is trading at 1.75%, 5y benchmark, PS0422, at 2.63% and 10y benchmark, DS0727, at 3.29%. The PS0422/DS0727 spread is 66/65 bps. We think that the curve should steepen.

IRS curve



Asset swaps





Money market

Waiting for CPI

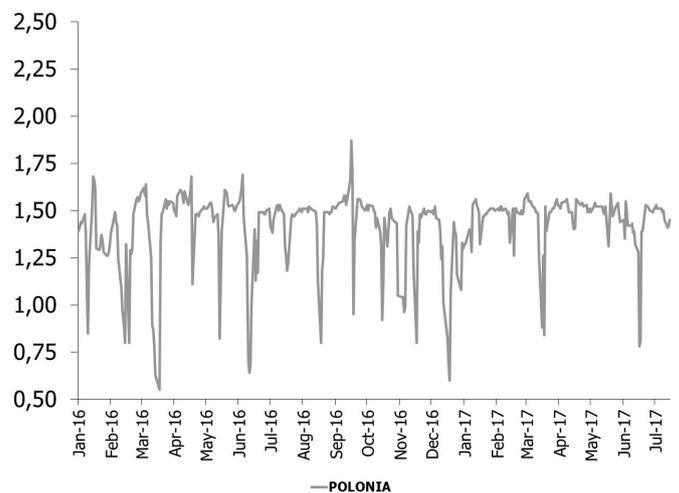
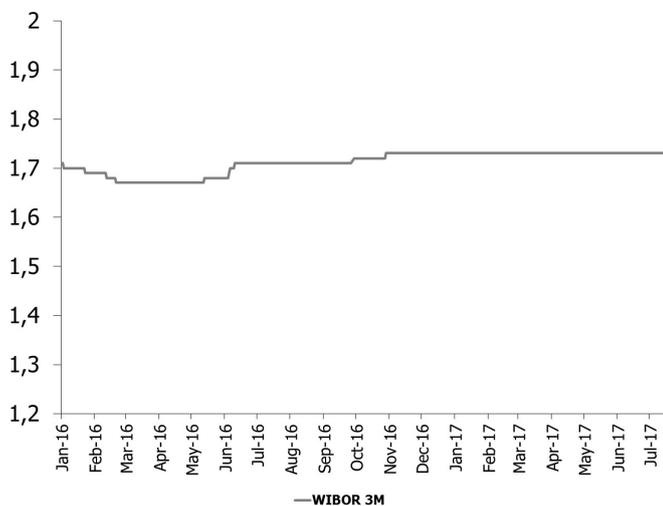
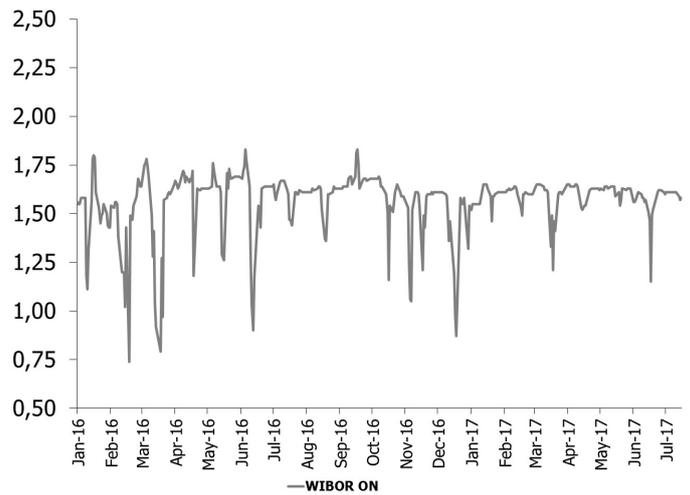
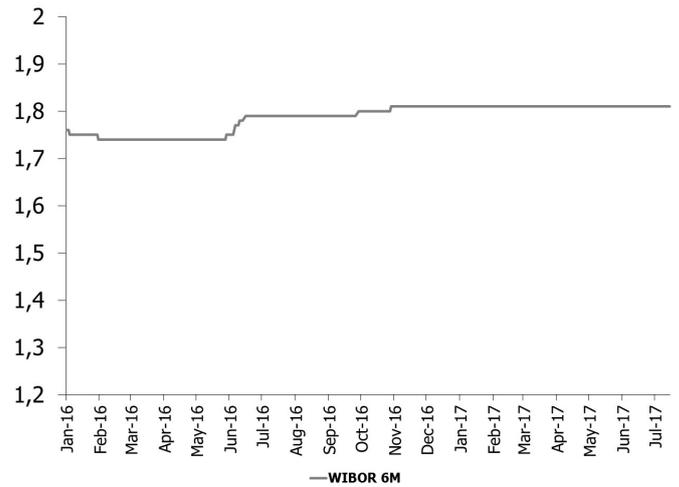
Front-end rates are slowly grinding higher with 2y trading close to recent highs. On Monday, flash CPI will be released. We will watch closely, if we have already reached a turning point. With hawks raising their concerns about holding rates low, returning to negative real rates can strengthen their position.

Stable end of the month is attributed to favourable calendar. Last day of reserve period came in line with NBP bills redemption. Bank can easily square positions on Friday.

Ref rate vs Polonia averages:

30 day 7 bp

90 day 3 bp



Forex

Spot: EUR/PLN – top of the range Last week important global events – meetings of ECB and the Fed (on Thursday and on Wednesday) failed to produce much of the volatility on PLN. This time local factor played first fiddle. On Friday EUR/PLN jumped from 4.2130 to 4.2680, due to the parliament passing the Supreme Court legislation which caused mass street protests. On Monday, zloty recovered to 4.2325 after Polish President Andrzej Duda partially vetoed disputed legislation to reform the judiciary; it was temporary relief, though. EUR/PLN come back soon afterwards to the top of our range and now it is trading in 4.26 proximity. We observe big nervousness as the European Commission (for the third time) informed Poland on looming sanctions if it sticks to the judicial reforms, which would put courts under government control, undermining the right for a fair trial. Warnings from Moody's only fanned the flames.

We see bigger risk of the breakout of the current range to the upside. In our view EUR/PLN needs to decisively breach 4.26-4.27 resistance zone to confirm that. On the upside, the next target is 4.2800 on the way to 4.30/32. Nevertheless, it would not be a straight line, as the rangy nature of EUR/PLN has to be taken into account.

EUR/PLN vols – tic higher Slightly weaker PLN and political developments were the reasons why the vols kept on creeping higher. The gains are cosmetic and we need higher realized volatility and/or weaker PLN to support these gains. EUR/PLN ATM mid is today 5.7% (0.1% higher), 3 months are 5.9% (0.1% higher) and finally 1 year fixed at 6.25% (0.05% higher). The currency spread (difference of USD/PLN minus EUR/PLN) is fixed approx. at 3.25% (USD/PLN vol is higher). Both EUR/PLN and USD/PLN risk reversals are roughly unchanged.

Short-term forecasts

Main supports / resistances:

EUR/PLN: 4.18 / 4.28

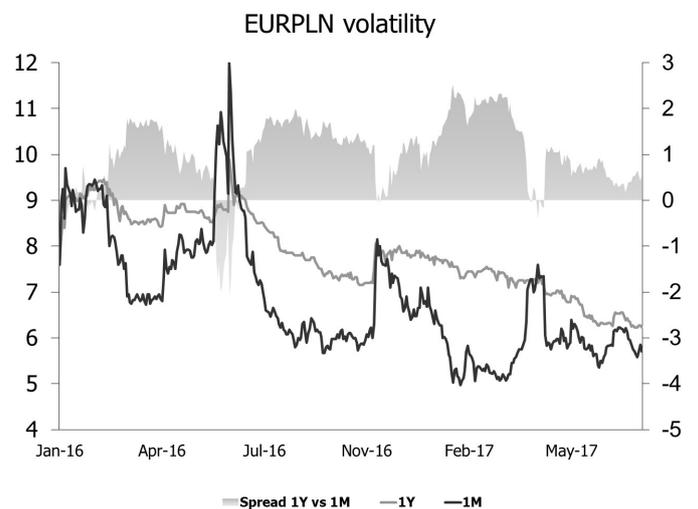
USD/PLN: 3.50 / 3.80

Spot Current position: Half of the long EUR/PLN (entered at 4.2150) closed at 4.2650.

Finally our long EUR/PLN at 4.2150 is in the money. We have closed half of our long at 4.2650 to book some profit. We are now ready to reenter the trade at 4.2150 with the stop at 4.1750 (for the full position) or to take profit out from the rest of the position at 4.30ish. The situation is far from being clear but for a choice we prefer to play the current range (4.21-4.26) from the short PLN side.

Options Vol – tactical long

Unchanged from last weeks. We reduced some vega position but still have small tactical long in mid curve Vega. The market is not really moving, we are in very tight price ranges. In the bigger picture, we are much more keen to enter bigger long Vega trade, but timing is key. For now we are sticking to our small tactical long.



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
7/20/2017	1.69	1.73	1.79	1.71	1.83	1.75	1.73	1.74	1.77	1.83	1.87	1.86
7/23/2017	1.67	1.73	1.81	1.71	2.00	1.75	1.73	1.74	1.78	1.81	1.87	1.86
7/24/2017	1.63	1.73	1.82	1.71	1.99	1.75	1.73	1.74	1.78	1.81	1.87	1.84
7/25/2017	1.54	1.73	1.64	1.71	1.82	1.75	1.73	1.74	1.77	1.83	1.89	1.85
7/26/2017	1.62	1.73	1.73	1.71	1.91	1.75	1.73	1.76	1.77	1.82	1.89	1.85

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
7/20/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/23/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/24/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/25/2017	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
7/26/2017	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	1Y
7/20/2017	5.58	5.88	6.00	6.23	6.23	1.89	0.56	0.56
7/23/2017	5.70	5.93	6.05	6.28	6.28	1.89	0.56	0.56
7/24/2017	5.85	5.98	6.05	6.28	6.28	1.91	0.58	0.58
7/25/2017	5.70	5.90	6.00	6.23	6.23	1.87	0.58	0.58
7/26/2017	5.65	5.93	6.00	6.28	6.28	1.92	0.58	0.58

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/20/2017	4.2117	3.6604	3.8276	3.2584	1.3760	0.1616
7/23/2017	4.2311	3.6320	3.8195	3.2503	1.3848	0.1622
7/24/2017	4.2413	3.6395	3.8489	3.2878	1.3900	0.1629
7/25/2017	4.2559	3.6519	3.8548	3.2824	1.3936	0.1636
7/26/2017	4.2611	3.6661	3.8404	3.2773	1.3935	0.1638

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