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Polish Weekly Review

mBank Research
(macro/FI/FX analysis)

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Comment on the upcoming data and forecasts

Next Friday, the NBP will release balance of payments data for June. We expect a sizeable increase in CA deficit (to ca. 1.9 bn EUR), which can be attributed to seasonal deterioration in income balance. Trade deficit should hold firm at 200 mio EUR. At the same time, the CSO will publish final CPI data for July. The slight upward surprise (more in the Economics section) is a result of higher food prices, in our view. The details of the release will confirm this.

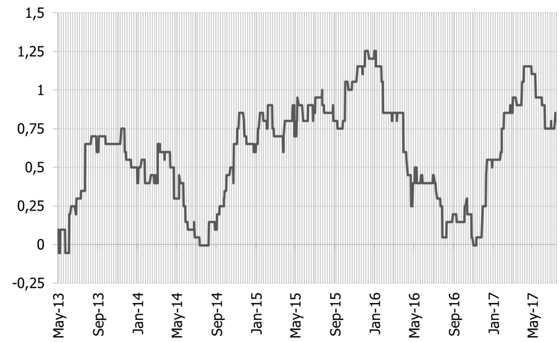
Polish data to watch: August 4th to August 11th

Publication	Date	Period	mBank	Consensus	Prior
Current account (mio EUR)	11.08	Jun	-1860	-750	-179
Exports (mio EUR)	11.08	Jun	16400	16577	16257
Imports (mio EUR)	11.08	Jun	16600	16457	16457
CPI *final* y/y (%)	11.08	Jul	1.7	1.7	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	9/8/2017	600	1.859	6/9/2017
5Y T-bond PS0422	9/8/2017	1000	2.587	6/9/2017
10Y T-bond DS0727	9/8/2017	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 the previous week: CPI surprised to the upside, while PMI surprised to the downside, cancelling each other out. Next week is rather empty of important macro releases. Unless the final CPI revises the flash reading, Polish surprise index should remain unchanged.

* 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.
- 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

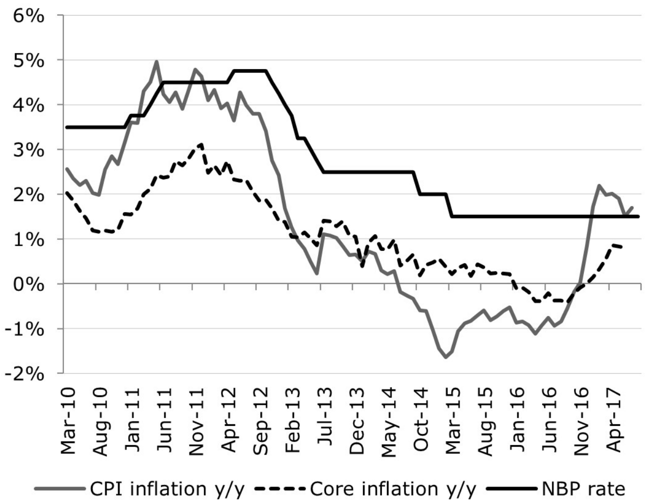
	2017 Q1	2017 Q2 F	2017 Q3 F	2017 Q4 F	2018 Q1 F	2018 Q2 F	2018 Q3 F	2018 Q4 F
GDP y/y (%)	4.0	3.8	3.8	3.9	4.0	4.0	4.2	4.2
Individual consumption y/y (%)	4.7	4.6	4.2	4.0	4.0	3.8	3.8	3.8
Public Consumption y/y (%)	1.0	2.0	2.5	3.0	4.0	3.0	3.0	3.0
Investment y/y (%)	-0.4	3.8	7.0	10.0	10.0	10.0	10.0	9.0
Inflation 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	3.58	3.50	3.50	3.45	3.40	3.35

F - forecast

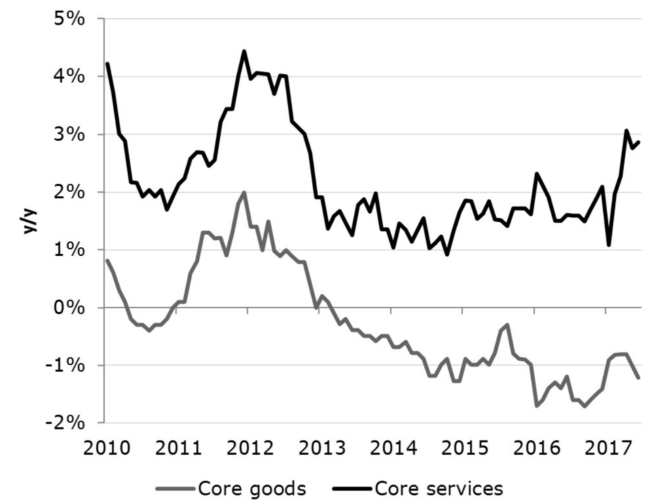
Economics

Polish CPI: where do we stand?

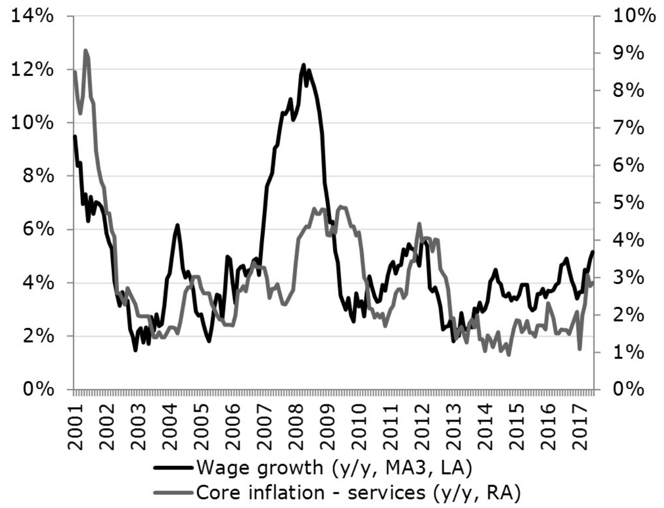
According to the flash estimate, consumer prices in Poland rose in July by 1.7% y/y (market expectations and our forecast: 1.6% y/y), up from 1.5% y/y in June.



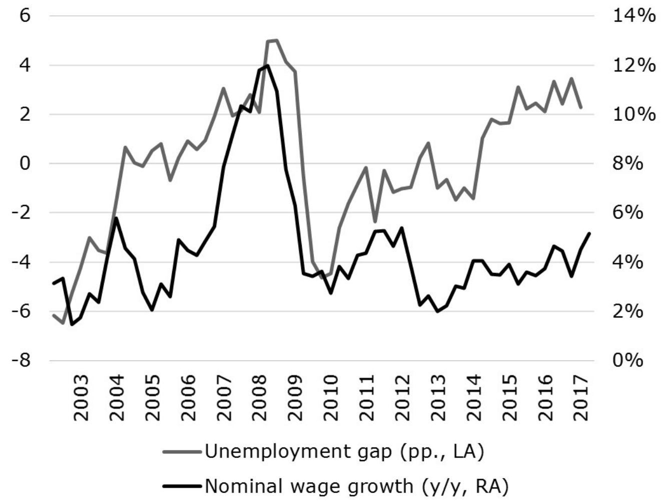
Right now, we can only speculate on the sources of this small surprise. The most obvious culprit are food prices. Our forecast of food prices (-0.6% m/m) was a compromise between signals from high-frequency data (smaller-than-usual decline in vegetable prices, increase in meat prices and prices of fats and oils – the latter clearly underestimated by the CSO vis-a-vis wholesale prices) and CSO's well-known tendency to smooth such swings out. Among other categories one could single out another drop in fuel prices (by 2% m/m), likely to be the last for some time (PLN-denominated oil prices increased by 10% from their mid-June levels). Further months will be marked by above-average readings of food prices, stabilization in fuel prices, and strong base effects at the turn of the year: fuel first, then food. The former should not be taken for granted. Even a few $ increase in oil prices could, at these levels, easily match the abovementioned base effect.



Core inflation likely held steady at 0.8% y/y in July, as higher prices of package holidays and an entrenched uptrend in Hotels and restaurants category matched the disinflationary effect of lower commodity prices and exchange rate appreciation. Core inflation nevertheless is the elephant in the room. The dichotomy between core services and core goods is obviously one of our favorite mantras. For good reason – the difference between their growth rates is at its highest since 2009, with core goods prices declining at a modest pace and core services rising at above-average rate (see the graph above). While the reasons for the difference are clear and well-known, one can ask a different question – why aren't core services prices growing faster? Historically, prices of services, due to their high labor intensity and low productivity growth, went hand in hand with wage growth, lagging it by 3-6 months (see the graph below). Yet, the multi-year uptrend in wages is consistent with faster service price growth.



However, wage growth itself lies below levels implied by the state of the labor market, i.e. the multi-decade lows in unemployment rate. Note that unemployment rate is even lower than purely cyclical factors would suggest – we draw this conclusion from a simple exercise, similar to the one, whose results (pertaining to fiscal variables) we presented last week. We regressed quarterly unemployment rate on industrial capacity utilization (a proxy for the output gap) and adjusted the residuals so that their average equaled the sample mean of unemployment rate. The difference between the two series can be called "unemployment gap". As the Readers can see, it used to correlate well with wage growth, but this is no longer the case.



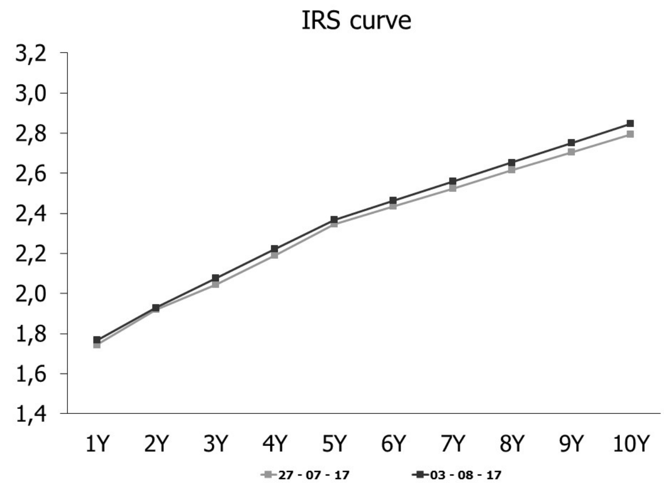
All in all, it should be obvious that inflation has not reacted to cyclical developments in the economy the way it used to in the past. In other words, the Philips curve is much more flatter than it used to be – a phenomenon seen throughout the world. The relationship is not completely broken, as it is sometimes alleged, but the sensitivity of inflation to cyclical factors / labor market is lower than before. Whether this is a permanent fixture, or a temporary distortion (it is often blamed on Ukrainian immigration, but the global nature of the phenomenon speaks against this explanation in no uncertain words), it remains to be seen. In any case, fundamentals still point to higher services price growth and, thus, continued uptrend in core inflation.

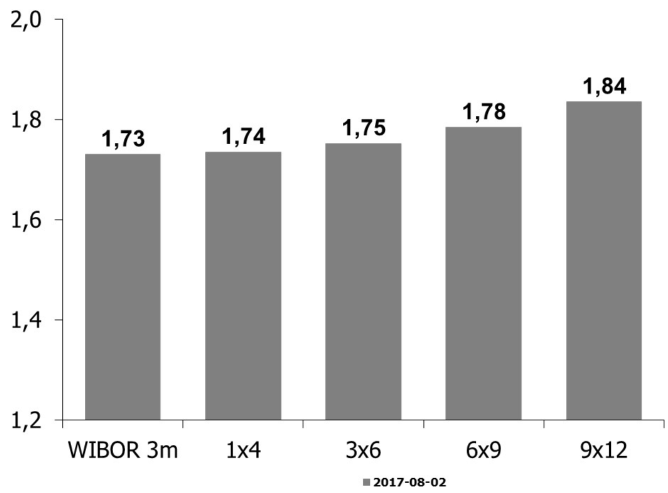
Fixed income

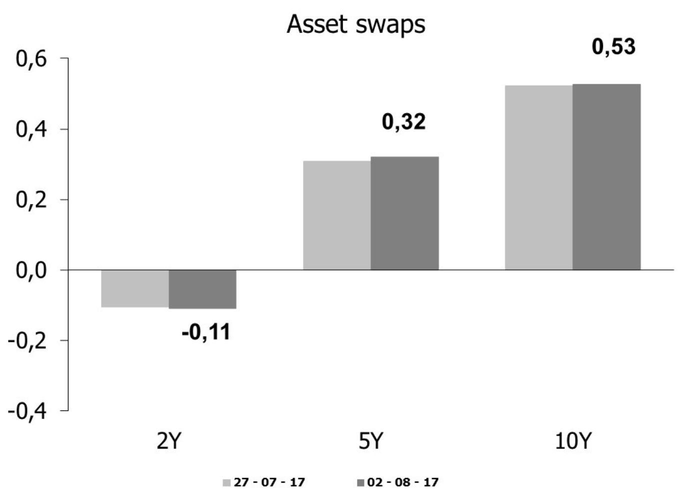
Bond supply to return soon

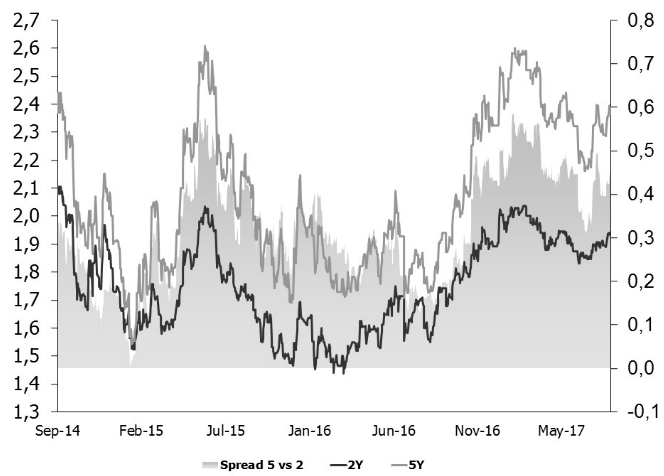
We had an auction this morning. The Ministry of finance sold a new 5y benchmark, PS0123, its spread over PS0422 was 12 bps. Almost 6 bn PLN of several bonds was sold. We don't see any willingness to buy the long end. Looks like political tensions are rising here, DS0727/Bund spread is 288 bps and it widened by 13 bps.

The PS0422/DS0727 spread widened from 66 to 68, PS0422/5y ASW is at 25 bps and DS0727/10y is at 46 bps. OK0419 is trading at 1.74% (1 bps down), PS0422 is trading at 2.65% (2 bps up) and DS0727 is trading at 3.33% (unchanged). ASWs have narrowed for the last few weeks as there was no supply on the primary market. Now it will change, we expect 2 auctions every month until the end of 2017.









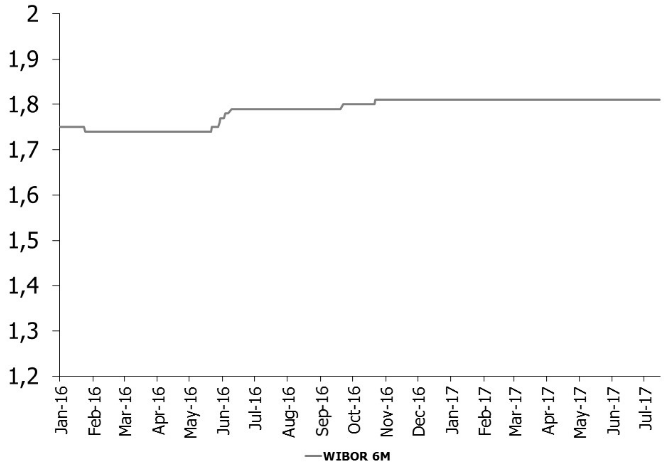
Money market

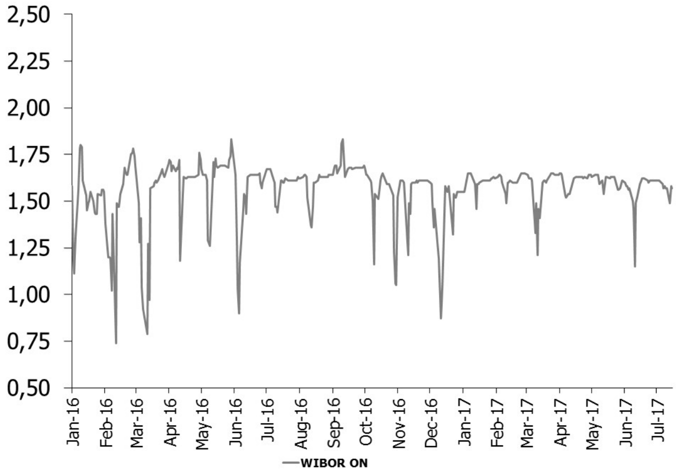
Heavy short end

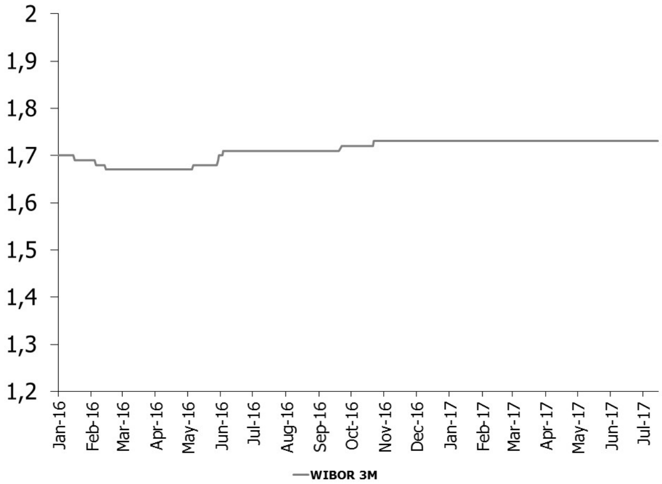
Flash CPI came out at 1.7%, slightly higher than expected 1.6%. This is fueling further rate hike bets in Poland. FRAs and short swaps are holding close to recent highs. Shortest bonds moved substantially compared to the swap curve. That's probably an outcome of recent lack of auctions and ALMs' willingness to hold bonds instead of cash, which is taxed. From the trading point of view, these bonds offer no value with yields lower than 1.50%.

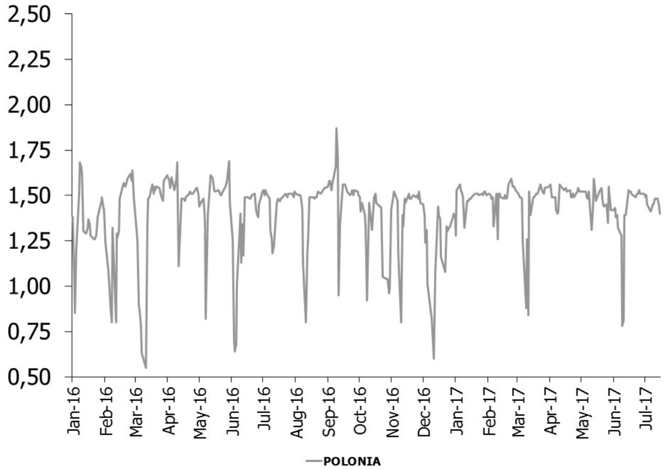
The month started with a big cash surplus, therefore overnight rate stood around 1.42%. Tomorrow we have new OMO, which should clear the surplus.

Ref rate vs Polonia averages:
30 day 7 bp
90 day 3 bp









Forex

Spot: EUR/PLN – oscillating around 4.2500 Volatility is at its lows, with EUR/PLN being glued to 4.25-ish. USD/PLN is still heading lower, mimicking EUR/USD ascent. As a result, the basket (50% of EUR/PLN and 50% of USD/PLN), points to stronger PLN. The new presidential CHF loan bill was not able to dent this positive Zloty mood. We doubt whether NFP data will be able to wake EUR/PLN up, either. The current range is still 4.22-4.27, for a choice we prefer to play that range from the short PLN side. It is mostly because of political risk, that is not really getting market attention, and not being discounted in the current PLN value.

EUR/PLN vols – roughly unchanged Realized volatility failed to impress, once again. We have seen trades in 1Y EUR/PLN ATM at 6.15 and 6.10%. The skew was trading in 1Y 25d RR at 1.8% and at 1.55% in the 6 month. The vols were offered heavily again. EUR/PLN ATM mid is at 5.6% today (0.1% lower), 3 month are at 5.9% (unchanged) and finally 1 year fixed at 6.15% (0.1% lower). The currency spread (difference of USD/PLN minus EUR/PLN) is bit higher thanks to higher EUR/USD vols. The skew was bid.

Short-term forecasts

Main supports / resistances:
EUR/PLN: 4.18 / 4.28
USD/PLN: 3.50 / 3.80

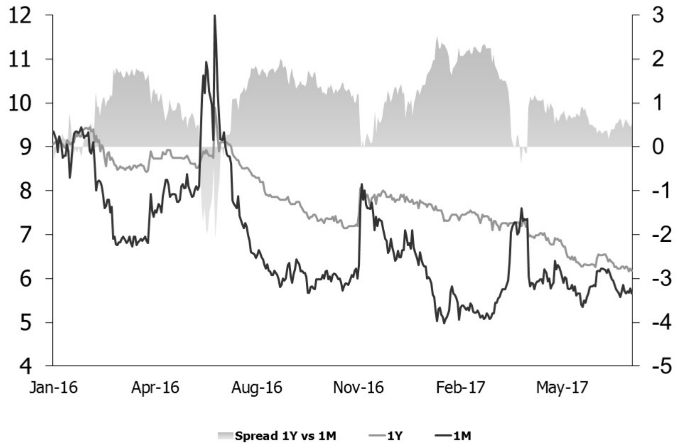
Spot Current position: Still long EUR/PLN, 50% of the original position (after partial profit-taking).

We are now ready to add to the trade at 4.2150 (with the stop at 4.1750 for the full position) or to take profit of the remainder at 4.30-ish. 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.

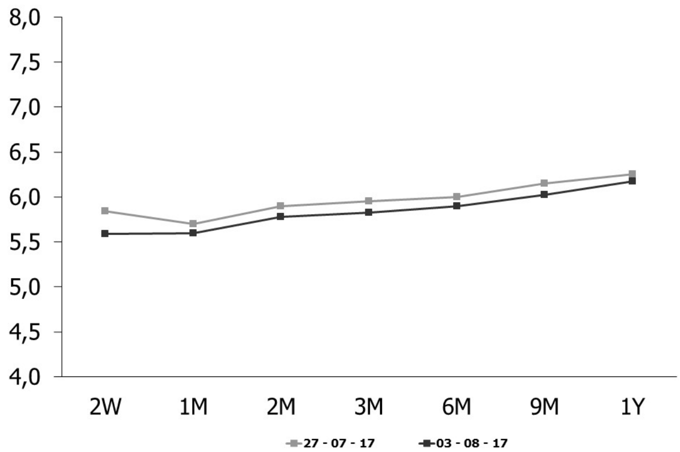
Options Vol – tactical long

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.

EURPLN volatility



EUR/PLN volatility curve



Bias from the old parity (%)

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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
7/27/2017	1.63	1.73	1.80	1.71	1.92	1.75	1.73	1.74	1.77	1.82	1.89	1.85
7/30/2017	1.63	1.73	1.75	1.71	2.00	1.75	1.73	1.74	1.77	1.83	1.89	1.85
7/31/2017	1.62	1.73	1.83	1.71	1.92	1.75	1.74	1.77	1.79	1.84	1.92	1.88
8/1/2017	1.51	1.73	1.65	1.71	1.82	1.75	1.73	1.76	1.78	1.84	1.89	1.87
8/2/2017	1.61	1.73	1.75	1.71	1.92	1.75	1.74	1.75	1.78	1.84	1.91	1.87

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
7/27/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/30/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
7/31/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/1/2017	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
8/2/2017	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
7/27/2017	5.70	5.95	6.00	6.25	6.25	1.91	0.57
7/30/2017	5.68	5.89	6.00	6.15	6.15	1.91	0.57
7/31/2017	5.78	5.98	6.00	6.23	6.23	1.88	0.56
8/1/2017	5.65	5.78	5.90	6.18	6.18	1.86	0.56
8/2/2017	5.60	5.83	5.90	6.18	6.18	1.85	0.57

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/27/2017	4.2650	3.6366	3.8116	3.2693	1.3970	0.1638
7/30/2017	4.2617	3.6406	3.7490	3.2718	1.3956	0.1635
7/31/2017	4.2545	3.6264	3.7381	3.2774	1.3959	0.1633
8/1/2017	4.2548	3.5991	3.7288	3.2611	1.4028	0.1627
8/2/2017	4.2515	3.5863	3.7081	3.2389	1.4010	0.1626

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