August 10, 2017

Polish Weekly Review

mBank Research
(macro/FI/FX analysis)

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Comment on the upcoming data and forecasts

This 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 is, according to the regional pattern, a result of higher food prices. Next week starts with publication of core inflation, which should stabilize at 0.8% y/y. On Wednesday we will have the icing on the cake – GDP growth in second quarter. Due to lower consumption growth as well as only partial rebound in investment, yearly index should have dropped to 3.8% from 4.0%. The next day brings us labour market data. Employment is set to stabilize at 4.3% y/y with modest growth on a monthly basis, some signs of bottlenecks could be already visible. Wages should decelerate slightly after last month's positive surprise, the trend is however still positive. Next week ends in a high note with real sphere data. Calendar and base effects are responsible for acceleration if both industrial (to 9.1% y/y) and manufacturing (to 13.1%) production. Growth in retail sale yearly index is modest (to 6.6% y.y), because effects of child subsidy programme ("500+") should start fading away. Last but not least, small change in producer prices index (from 1.8% to 2.0%) is a result of insignificant growth of commodities and PLN exchange rate.

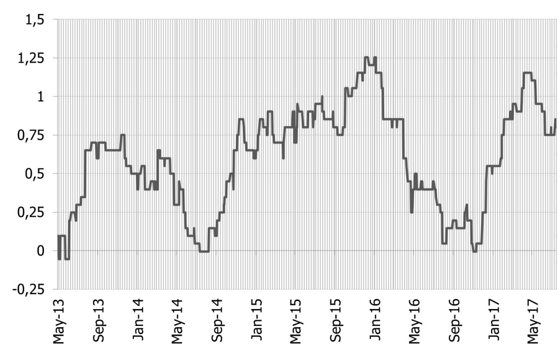
Polish data to watch: August 11th to August 18th

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	1.7
Core inflation y/y (%)	14.08	Jul	0.8	0.8	0.8
GDP y/y (%) *flash*	16.08	Q2	3.8	3.8	4.0
Average wage y/y (%)	17.08	Jul	5.4	5.4	6.0
Employment y/y (%)	17.08	Jul	4.3	4.3	4.3
Industrial production y/y (%)	18.08	Jul	9.1	8.4	4.5
PPI y/y (%)	18.08	Jul	2.0	2.0	1.8
Retail sales y/y (%)	18.08	Jul	6.6	7.9	6.0

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

There were no opportunities to surprise last week, but this will change soon. Next week is abundant with economic releases with CPI, GDP, labour market and real sphere data in the calendar.

* 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

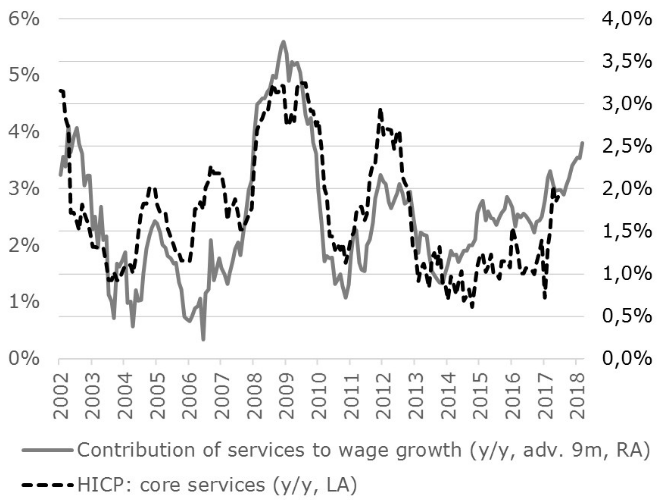
	2017 Q1	2017 Q2 F	2017 Q3 F	2017 Q4 F	2018 Q1 F	2018 Q2 F	2018 Q3 F	2018 Q4 F
GDP y/y (%)	4.0	3.8	3.8	3.9	4.0	4.0	4.2	4.2
Individual consumption y/y (%)	4.7	4.6	4.2	4.0	4.0	3.8	3.8	3.8
Public Consumption y/y (%)	1.0	2.0	2.5	3.0	4.0	3.0	3.0	3.0
Investment y/y (%)	-0.4	3.8	7.0	10.0	10.0	10.0	10.0	9.0
Inflation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

Something wicked this way comes

Last time we presented something resembling the Phillips curve for Poland and suggested that wages are accelerating, according to standard economic theory, but the pace of acceleration falls short of the 2006-2008 period, 2006-2008 when there were indeed wage pressures in the Polish economy. This shortfall is crucial to future predictions of inflation (see the graph that offers not only an illustration but also a useful forward looking prediction) and, hence, the behavior of market interest rate expectations. The baseline, as used to be backed by current market consensus (and the MPC) is that wage acceleration will proceed, albeit at pace consistent with the recent trends. This is a scenario that implies ca. 6% growth in wages and persistence of the gap between wage growth implied by historical Phillips curve and predicted wage growth. Not once we argued that we are on the brink of a burst of wage pressure. We feel that the market may start treating such warnings seriously as press coverage of the labor market is growing exponentially. Something wicked this way comes.



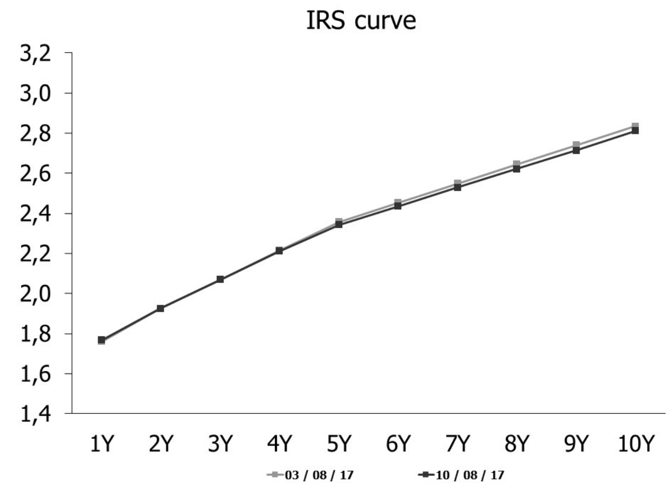
As seen in the above graph, the behavior of wage inflation is crucial to inflation in services which can easily be derived from standard economic theory. Having said that we may argue that services inflation is crucial in determining the persistence of inflation overall given its gear to domestic developments and the structure of consumption. What do we know on labor market of services?

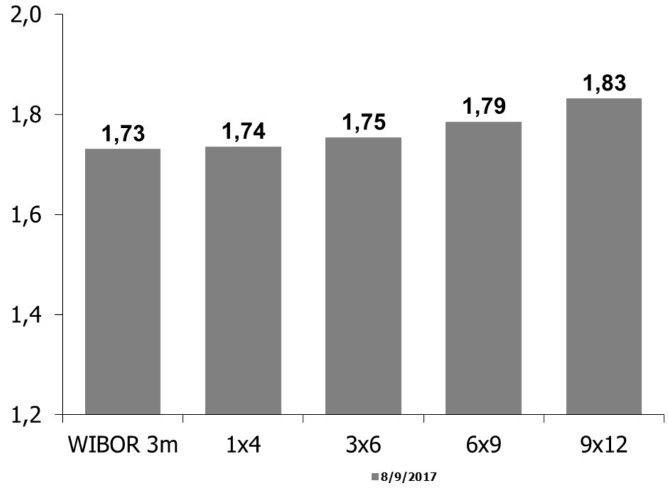
1. Its contribution to employment growth is close to the peak of the 2006-2008 cycle. Hence, labor demand in services stays high.
2. Firms from service sector complain on the shortage of (qualified staff) more or less the same as they did in 2006-2008. The intensity of shortages in manufacturing has already passed the peak witnessed in 2006-2008 (we mention this fact as a pure curiosity).
3. Contribution of service sector to overall wage growth is closest to 2006-2008, when compared to other major sector groupings (construction, mining, industry). However, wage pressure is not limited to this sector, so we cannot speak of Dutch diseases, or any asymmetric shocks. The whole labor market is tightening, but services seem to be leading the way.
4. Overall supply of labor (potential and already working) as measured by the participation rate is much higher than in 2006-2008, while the unemployment rate â€“ lower. Therefore, it is fairly easy to argue that demand-supply conditions are worse than in 2006-2008. Changes in retirement age only complicate the matter.
5. It can be seen that all problems mentioned before seem to be offset in the public debate by the potential inflow of Ukrainians that (and this is true) came in flocks to work in Poland (it is estimated that around 0.8-1 million Ukrainians are working in Poland). It is also true that recently they lifted their wage expectations substantially (20-30%) and the effects of this remain to be seen in the official data soon. This reservoir of cheap labor is emptying.
6. Ukrainians perform mostly simply, menial jobs. Hence, the lowest paid ones. We discovered that in the upswing phase of the cycle the distribution of wages is becoming more egalitarian (the lowest paid workers enjoy the highest pay increases). This applies to this cycle and to the cycle of 2006-2008 and the intensity of the process seems more or less the same. It bears the question then, what the labor market would had looked like if Ukrainians had been gone (had never arrived in such great numbers) or, in other words, if they had been granted more bargaining power. It seems that we are likely to this alternative world fairly soon and this will be the world of wage pressure.

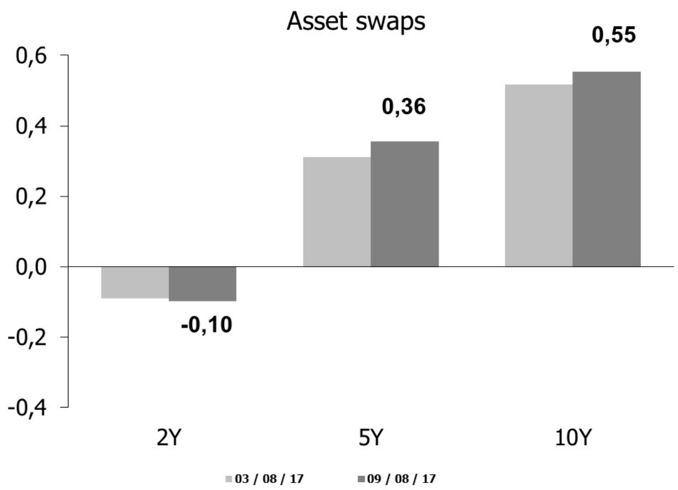
Fixed income

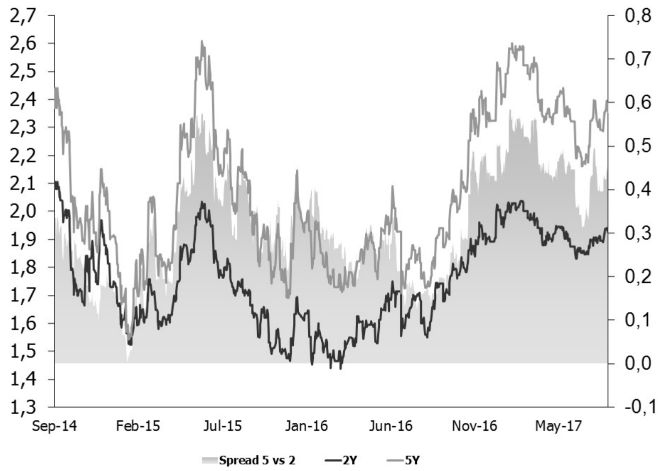
The loneliness of the long-end buyers

It looks like no one wants POLGBs. DS0727/Bund is at 300bps, it widened 12bps last week. Market is very heavy, curve is steepening, PS0422/DS0727 widened from 68 to 70, ASW PS0422/5y is at 31bps and DS0727/10y is at 55bps. OK0419 is trading at 1.73% (1bps down), PS0422 is trading at 2.7% (5bps up) and DS0727 is trading at 3.4% (7bps up). ASW have been narrowing for the last few weeks and now it may hit Polish floaters, especially WZ0124 and WZ0126.









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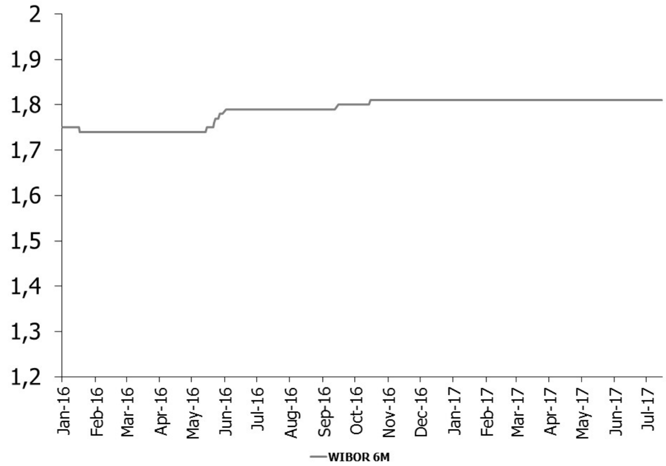
Money market

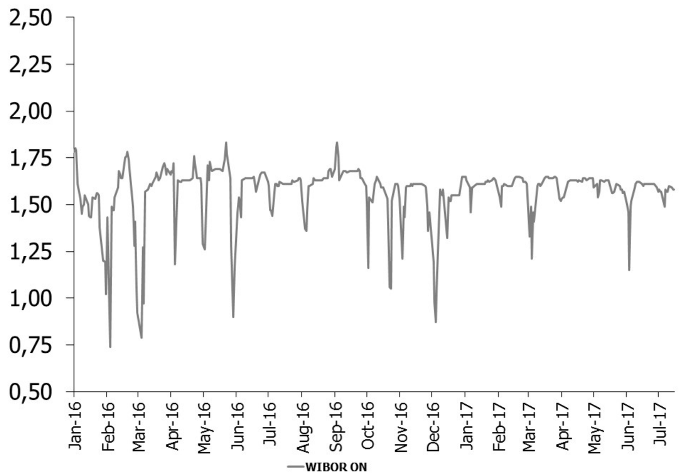
Can I play with steepness?

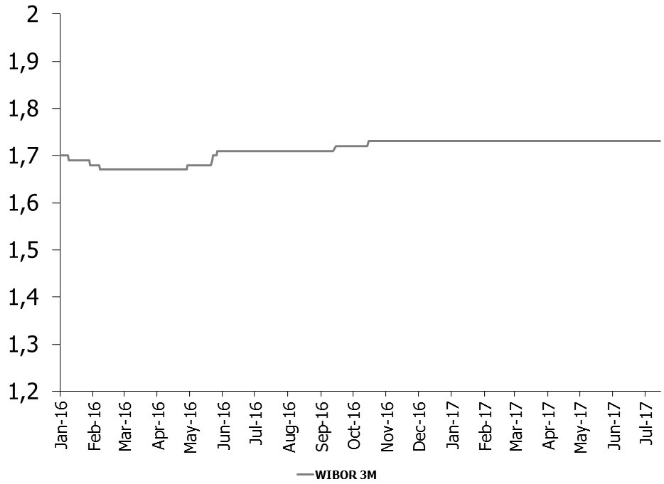
Summer time keeps us quite busy. Polish bond curve suffers from a split personality. Shortest bonds are in big demand – nearly 6 bio of T-bills mature in August and ALM desks need to replace those. With no auction on the horizon until September, they buy on the secondary market. On the other hand, if we look at 5 year horizon and beyond, market feels very heavy. Prices are falling and ASW spreads are widening every day. I would be vary cautious in catching the knife. If we look at the charts there is still plenty of room for yields to rise.

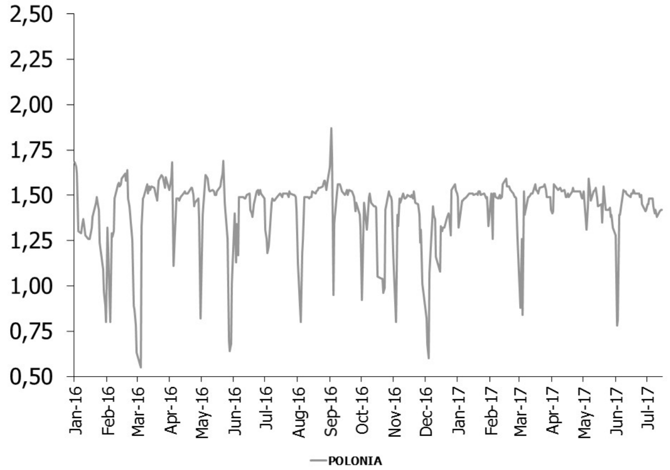
Another cheap week with overnight rate around 1.42%. It feels like that's already a rule that market players leave few bio surplus each week.

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









Forex

Spot: EUR/PLN – in the higher part of the range EUR/PLN is currently testing the 4.27-4.29 resistance zone, USD/PLN bounced from this year's low of 3.5650 to 3.6450ish. Looks like it is USD/PLN that is the key driver of Zloty basket (50% EUR and 50% USD) at the moment. The correction in USD downtrend translated into weaker PLN, but it is still work in progress. The risk-off from North Korea is probably to be faded, but if USD keeps on correcting higher, PLN will keep on suffering. We still be skewed to play the market rather from short PLN side.

EUR/PLN vols – lower Realized volatility is once again on the decline, and vols are melting as well. Only weaker PLN, on the back of the mild risk-off mood, is preventing the vols from being crushed even more. EUR/PLN ATM mid is today 5.3% (0.3% lower), 3 month is 5.7% (0.2% lower) and, finally, 1 year fixed at 6.10% (0.05% lower). The currency spread (difference between USD/PLN and EUR/PLN) is bit higher thanks to higher EUR/USD vols. The skew was slightly bid.

Short-term forecasts

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

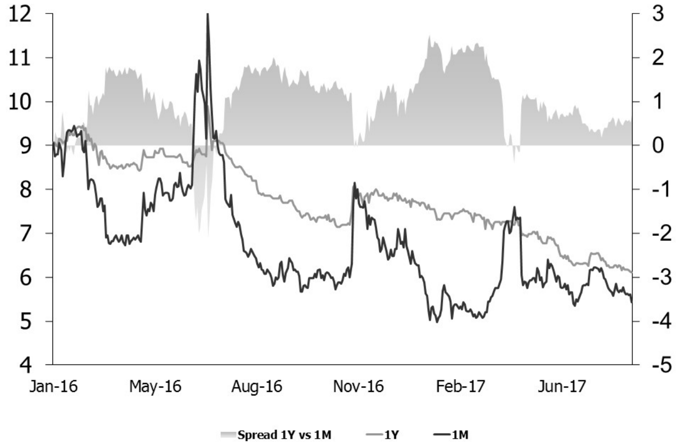
Spot Current position: Still long EUR/PLN, 50% of the original position (after partial profit-taking).

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.

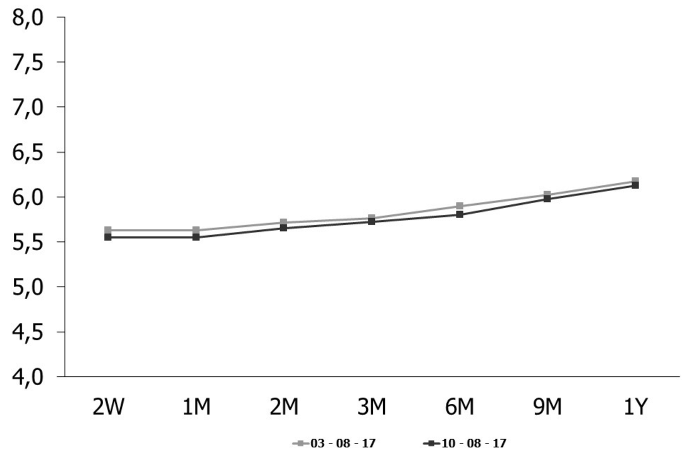
Options Vol – tactical long

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.

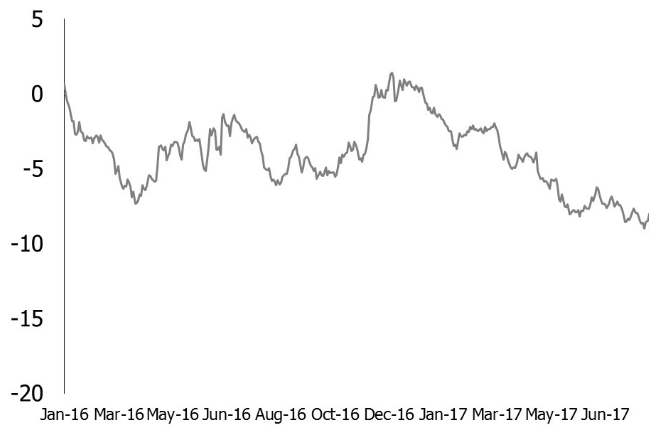
EURPLN volatility



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
8/3/2017	1.62	1.73	1.75	1.71	1.92	1.75	1.74	1.76	1.79	1.84	1.90	1.87
8/6/2017	1.62	1.73	1.75	1.71	1.90	1.75	1.74	1.76	1.80	1.84	1.92	1.88
8/7/2017	1.62	1.73	1.67	1.71	1.72	1.75	1.74	1.75	1.78	1.83	1.90	1.87
8/8/2017	1.51	1.73	1.65	1.71	1.81	1.75	1.74	1.75	1.78	1.83	1.90	1.87
8/9/2017	1.62	1.73	1.67	1.71	1.72	1.75	1.74	1.75	1.79	1.83	1.90	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
8/3/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/6/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/7/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
8/8/2017	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
8/9/2017	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
8/3/2017	5.63	5.76	5.90	6.18	6.18	1.86	0.57
8/6/2017	5.59	5.81	5.93	6.16	6.16	1.86	0.57
8/7/2017	5.61	5.79	6.00	6.13	6.13	1.87	0.59
8/8/2017	5.43	5.64	5.78	6.11	6.11	1.86	0.57
8/9/2017	5.55	5.73	5.80	6.13	6.13	1.82	0.59

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/3/2017	4.2538	3.5918	3.7072	3.2454	1.4014	0.1629
8/6/2017	4.2423	3.5702	3.6898	3.2427	1.3958	0.1626
8/7/2017	4.2469	3.5995	3.7018	3.2492	1.3963	0.1623
8/8/2017	4.2541	3.6027	3.7036	3.2587	1.3974	0.1626
8/9/2017	4.2638	3.6342	3.7693	3.3118	1.3987	0.1632

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