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Polish Weekly Review

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Comment on the upcoming data and forecasts

This week will be marked by the MPC meeting. As in the previous cases, we do not expect anything spectacular from here. Inflation has comfortably fallen from November's high. It is true, though, that both inflation and GDP paths lie north of those suggested in the latest inflation projection. It is also true that MPC would leave the verification of this fact – especially with respect to the evolution of inflation over the medium term – until the time when the fresh inflation projection is released i.e. to March. All in all, the MPC is going to stay dovish without any change in guidance. Balance of risks shifts to the dovish side given recent PLN appreciation.

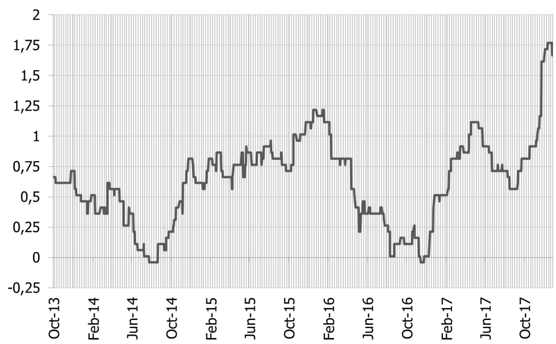
Polish data to watch: January 5th to January 12th

Publication	Date	Period	mBank	Consensus	Prior
MPC Decision (%)	10.01	Jan	1.50	1.50	1.50

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	1/30/2018	860	1.863	1/4/2018
5Y T-bond PS0422	1/30/2018	1800	2.561	1/4/2018
10Y T-bond DS0727	1/30/2018	800	3.338	11/23/2017
30Y T-bond WS0447	-	125	3.720	10/25/2017

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



Comment

CPI came out below market consensus, thereby bringing about a minor correction to the Polish surprise index. Next week is a light one (only the MPC meeting), so the index will stay flat.

* 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

- In 2018 Polish GDP is set to grow by 4.5%. Poland is entering the upcoming election cycle (local elections in 2018, parliamentary elections in 2019 and presidential elections in 2020) with very tight labor market, favorable external environment and stimulation on all fronts.
- Inflation reached a local top in November 2017. Base effects suggest that inflation will drop at the turn of the year and reaccelerate briskly from Q2 on. One should look through short-term fluctuations and look at underlying momentum. The case for accelerating core inflation is strengthening. Polish labor market is operating normally and fits regional trends: wage inflation is coming.
- MPC stays calm and waves away any signs of intensifying wage pressure. Such rhetoric can stay in place for some months, especially when inflation temporarily drops on base effects. 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.
- Fiscal situation continues to be very comfortable and GG deficit will fall below 2% of GDP this year. We judge that the increase in VAT revenues is 70% consumption growth and 30% crackdown on tax avoidance. The latter has not ended and the prospects for increases in tax collectibility are very good.

Financial markets

- Political issues moved into the background and the markets are clearly unconcerned with local risks, making the PLN a star performer in the region.
- The key reason for the recent PLN strength is the Goldilocks economy, both in Poland and abroad. Strong growth amid low inflation and range-bound global risk free rates is a recipe for inflows and appreciation of EM assets across the board. In such an evironment, PLN remains strong.
- Such an equilibrium is unlikely to persist for long, though. Something has to give in and in either scenario (strong growth and inflation, leading to higher rates globally, or lower growth, higher risk aversion and outflows from EMs) negative real interest rates and dovish MPC will become a liability. Thus, before Zloty strengthens again due to cyclical factors, we might see some weakening in the meantime (to 4.30).

mBank forecasts

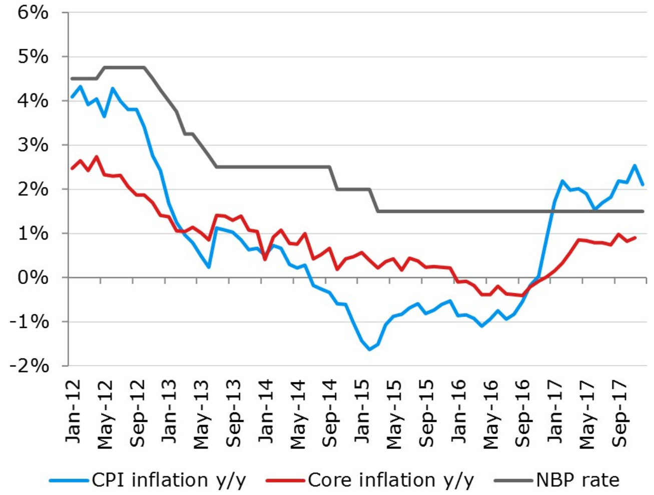
	2013	2014	2015	2016	2017 F	2018 F
GDP y/y (%)	1.4	3.3	3.8	2.9	4.3	4.5
CPI Inflation y/y (average %)	0.9	-0.1	-0.9	-0.6	1.9	2.2
Current account (%GDP)	-1.2	-2.1	-0.5	-0.3	-0.9	-1.1
Unemployment rate (end of period %)	13.4	11.4	9.8	8.2	6.6	6.0
Repo rate (end of period %)	2.50	2.00	1.50	1.50	1.50	2.00

	2017 Q1	2017 Q2	2017 Q3	2017 Q4 F	2018 Q1 F	2018 Q2 F	2018 Q3 F	2018 Q4 F
GDP y/y (%)	4.1	4.0	4.9	4.7	4.7	4.5	4.5	4.5
Individual consumption y/y (%)	4.7	4.9	4.8	4.5	4.5	4.2	4.0	4.0
Public Consumption y/y (%)	0.5	2.1	1.9	3.0	4.0	3.0	3.0	3.0
Investment y/y (%)	-0.5	0.9	3.3	7.5	10.0	10.0	9.0	8.0
Inflation rate (% average)	2.0	1.8	1.9	2.0	1.6	2.3	2.5	2.5
Unemployment rate (% eop)	8.0	7.0	6.8	6.6	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	1.72	1.72	1.72	1.98	2.23
2Y Polish bond yields (% eop)	2.01	1.90	1.75	1.72	1.91	2.10	2.36	2.59
10Y Polish bond yields (% eop)	3.49	3.32	3.37	3.30	3.46	3.61	3.82	4.02
EUR/PLN (eop)	4.23	4.23	4.31	4.18	4.20	4.20	4.15	4.10
USD/PLN (eop)	3.97	3.70	3.65	3.48	3.50	3.50	3.43	3.39

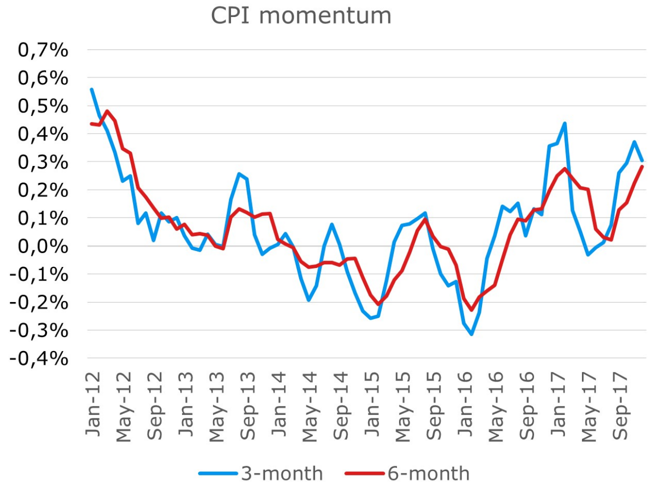
F - forecast

Inflation ends the year at 2.0% y/y due to base effects

Flash reading suggests inflation dropped to 2.0% y/y at year end. The fall is a bit more pronounced than our forecast (2.1%) but all in all the deceleration stems from base effects in prices of food and fuels. The discrepancy between our forecast and the reading may have been primarily caused by food prices. They may have increased little less than +0.6% m/m we had assumed. We do not really expect the core prices to be important for our forecast's miss. Therefore, we keep their estimate at 0.9% y/y.



Next two months are set to bring a further, temporary drop in inflation, led by base effects – this time mostly in food prices. Current trends in food prices (possible further drops of dairy prices and meats) may exacerbate these effects a bit. However, the general picture stays unchanged. Lower inflation is driven by exogenous factors and base effects. Theoretically, nothing that could bother the MPC. The more so since core inflation is likely to accelerate mildly. Traditionally, the start of the year may be convenient for the correction of prices, the more so since higher labors costs are starting to bite and demand stays at elevated levels. The current momentum in inflation stays decent. In the 5-year time span it is dwarfed only be the last year's exaggerations, driven by extraordinary high food prices. This time 0.3% momentum should be generated out of the strength of the economy.



As MPC treats inflation target symmetrically, recent rise of inflation was not a cause for concern. Also the discrepancy of the inflation projection and the reality is going to be rather neglected – at least for some time. MPC's rhetoric stays dovish and pins down market expectations. One hike is fully priced in for 2018. We do not think that the expected temporary drop in inflation is likely to put off those expectations. One issue is the discrepancy between current inflation and projection which me already mentioned (current inflation is running higher), another – are cyclical factors which inevitably should lead to higher rates.

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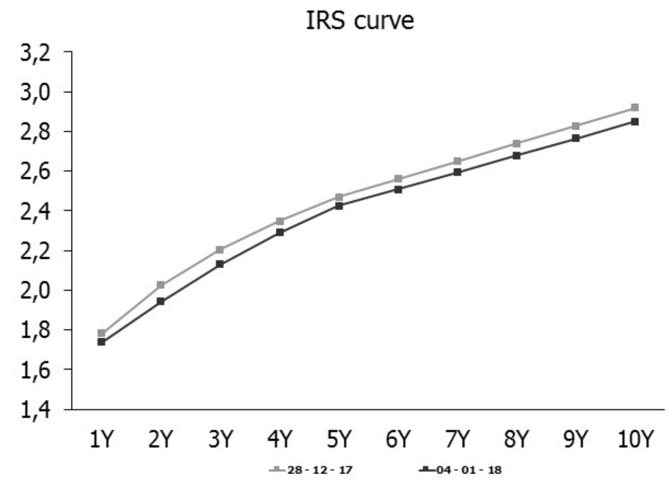
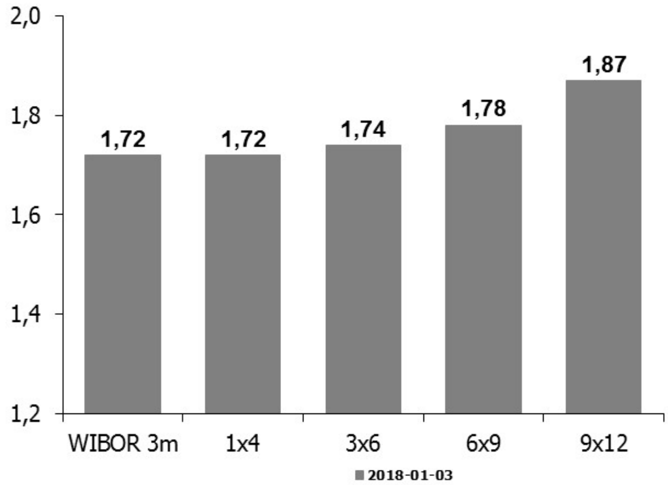
Fixed income

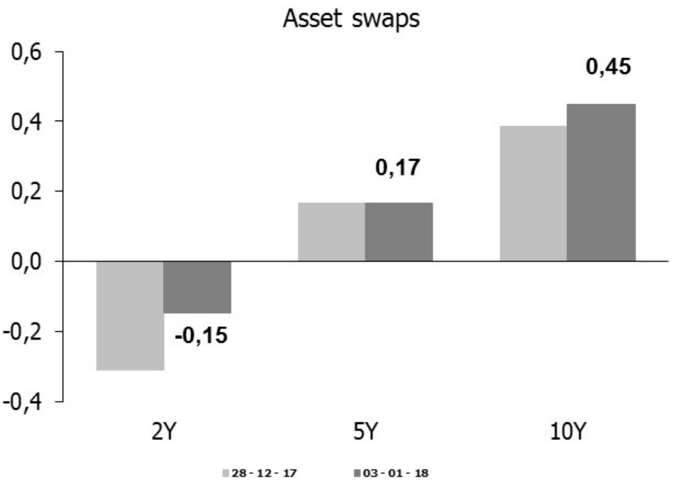
The whole curve moved lower amid a strong auction

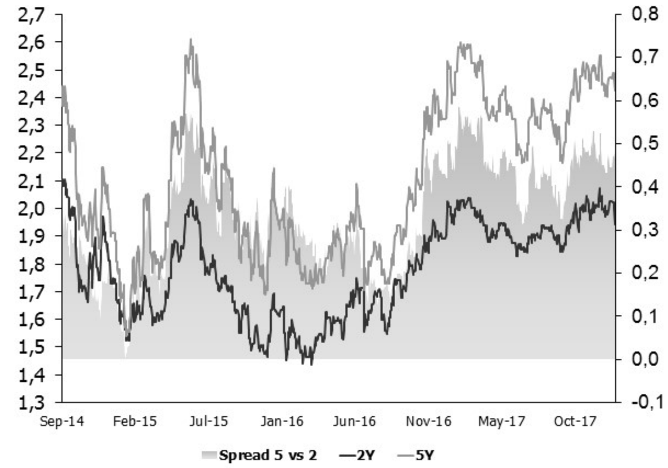
Today Polish Finance Ministry sold bonds on a regular auction. They sold 6 bn PLN, bid to cover ratio was 2.4. It was a strong auction. The curve is extremely steep again, PS0123/DS0727 is 68 bps. DS0727/Bund is 280 bps, PS0123/5y is 13 bps and DS0727/10y is 39 bps.

DS1019 is trading at 1.61% (10 bps down), PS0123 is trading at 2.56% (10 bps down) and DS0727 is trading at 3.24% (10 bps down).









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Money market

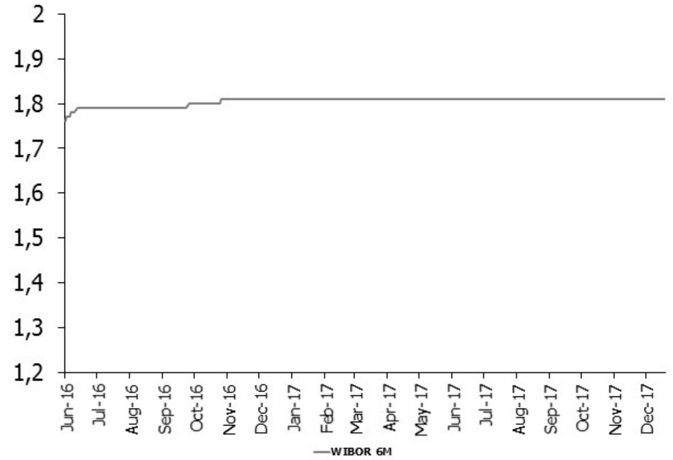
Strong start to 2018

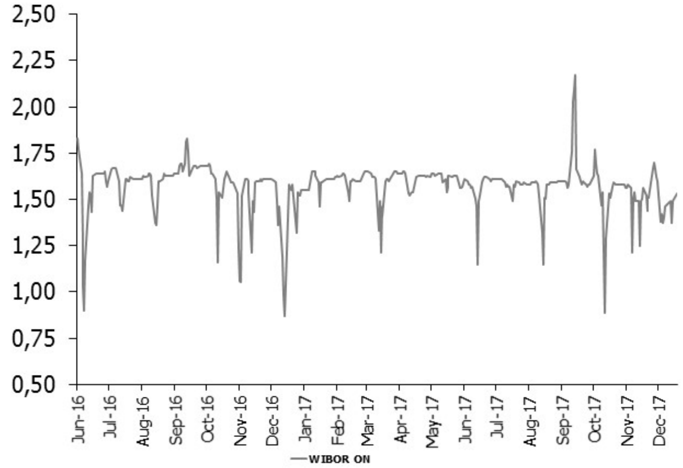
Strong start of 2018 for Polish assets. Bonds are being bought, zloty is strengthening and swap rates are falling. Feels like bank books released some extra liquidity they held over year end and stepped in on the bonds market. With poor liquidity and CPI heading lower (base effects) move got us to lows on yields. Remember base effects will last a quarter and than we should return to higher reading although as of now it puts some pressure of the MPC. Currently we are pricing around 50 bp hikes in 2 year horizon. We would say that’s not a lot, but with our stubborn MPC even that might be too much.

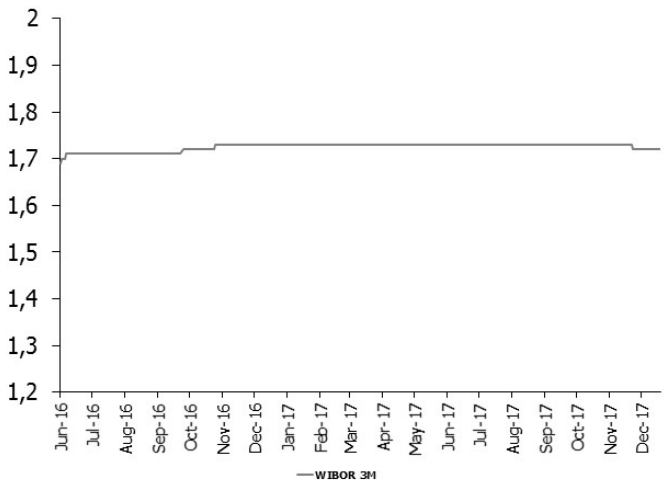
Spare liquidity from year end persists and overnight rates stay pretty low.

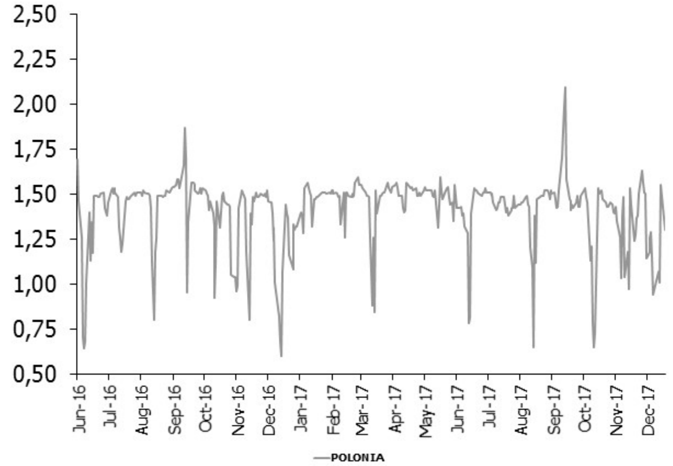
Ref rate vs Polonia averages:

30 day	20 bps
90 day	18 bps









Forex

Spot – Zloty is shining like gold According to various sources, the Zloty (in Polish it means „golden") has been the best performing currency in absolute terms. USD/PLN dropped to the levels seen last in Q4 of 2014 and CHF/PLN came back to the levels from 1Q of 2015. The investment sentiment worldwide is really strong, and PLN is just one of its beneficiaries. On the local front, the market cherished Poland's strong fundamentals and totally ignored the potential political consequences of EU triggering article 7 against Poland. We have our doubts, but the price action has to be respected nevertheless.

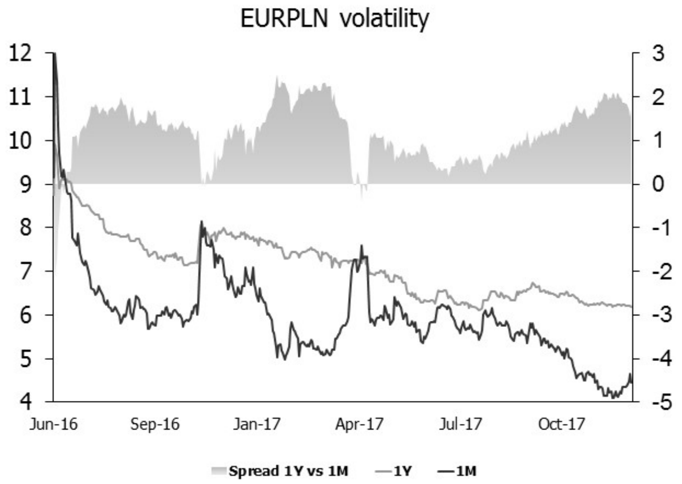
Options – volatility melting further The mix of stronger PLN and low realized vols is responsible for the continuation of vols melting. Front end implied vols are already at its historical lows, so the sell-off extended to the middle and back end of the curve. 1 month ATM mid is 4.1% today (0.1% lower), 3 month is at 4.8% (0.2% lower) and finally 1 year fixed at 6.1% (0.1% lower). The skew as well as the currency spread (difference between USD/PLN and EUR/PLN) were better offered.

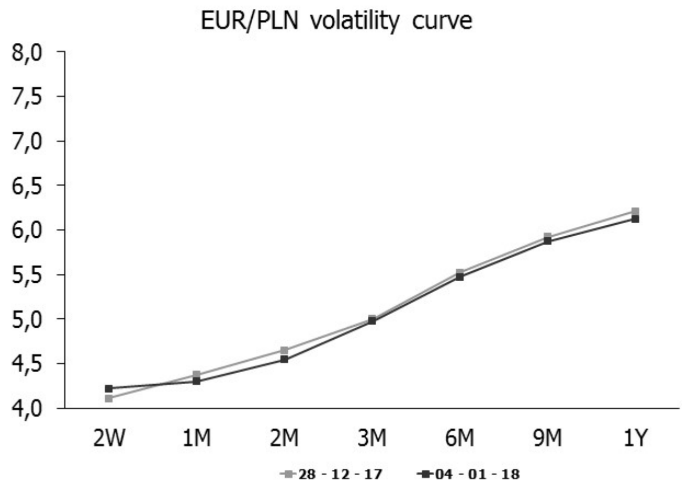
Short-term forecasts

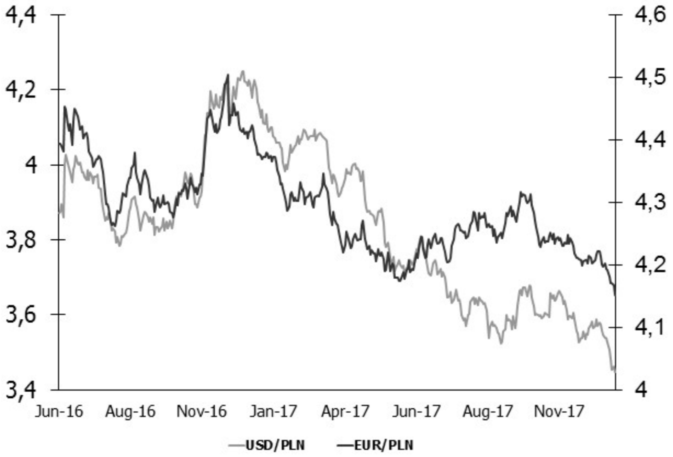
Main supports / resistances:
EUR/PLN: 4.13 / 4.23
USD/PLN: 3.35 / 3.60

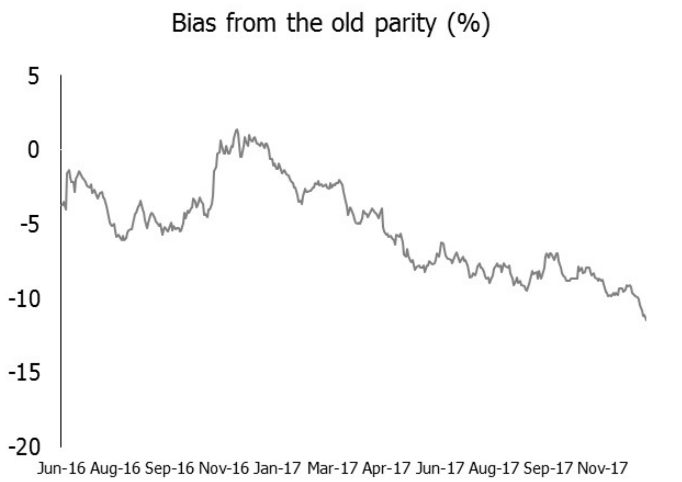
Spot Current position: Long EUR/PLN at 4.1970.

Our long in EUR/PLN from 4.1970 was stopped out at 4.1600. We moved to the sidelines for the time being.









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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
12/28/2017	1.70	1.72	1.80	1.71	2.00	1.75	1.72	1.74	1.79	1.89	2.00	1.88
12/31/2017	1.73	1.72	1.82	1.71	1.99	1.75	1.72	1.74	1.78	1.88	1.99	1.87
1/1/2018	1.73	1.72	1.82	1.71	1.99	1.75	1.73	1.75	1.79	1.90	2.01	1.87
1/2/2018	1.47	1.72	1.55	1.71	1.61	1.75	1.72	1.74	1.79	1.90	2.02	1.88
1/3/2018	1.75	1.72	1.86	1.71	2.05	1.75	1.72	1.74	1.78	1.87	1.96	1.86

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
12/28/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
12/31/2017	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/1/2018	1.750	1.474	1.635	1.578	1.960	2.232	2.405	2.949
1/2/2018	1.750	1.474	1.635	1.638	1.990	2.290	2.447	2.985
1/3/2018	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
12/28/2017	4.38	5.00	5.53	6.21	6.21	1.55	0.52
12/31/2017	4.48	5.10	5.58	6.20	6.20	1.55	0.52
1/1/2018	4.65	5.15	5.58	6.20	6.20	1.45	0.52
1/2/2018	4.45	5.00	5.50	6.18	6.18	1.44	0.53
1/3/2018	4.30	4.98	5.48	6.13	6.13	1.43	0.53

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
12/28/2017	4.1815	3.5046	3.5716	3.1038	1.3470	0.1633
12/31/2017	4.1709	3.4813	3.5672	3.0913	1.3449	0.1632
1/1/2018	4.1709	3.4813	3.5672	3.0913	1.3449	0.1632
1/2/2018	4.1701	3.4546	3.5567	3.0776	1.3470	0.1633
1/3/2018	4.1673	3.4616	3.5592	3.0829	1.3467	0.1629

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