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Polish Weekly Review

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Comment on the upcoming data and forecasts

This Friday the NBP will release revised quarterly balance of payments figures for the first quarter of 2018. Next week will begin with Polish Manufacturing PMI for June. We expect a slight increase in the index, somehwat contrary to the behavior of CSO's business sentiment indicators and soft data on German manufacturing. Flash CPI for June will also be published on Monday. We expect inflation to rise (from 1.7 to 2.0% y/y – in line with market consensus) on the back of higher fuel prices and slightly faster core inflation.

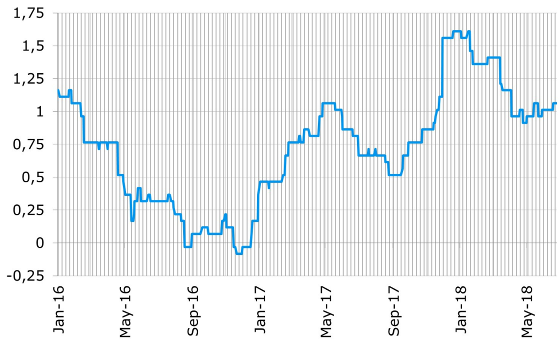
Polish data to watch: June 29th to July 6th

Publication	Date	Period	mBank	Consensus	Prior
Balance of payments quarterly	29.06	Q1			
PMI (pts.)	02.07	Jun	53.4	53.1	53.3
Flash CPI y/y (%)	02.07	Jun	2.0	2.0	1.7

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 OK0720	7/12/2018	20	1.637	5/24/2018
5Y T-bond PS1023	7/12/2018	1400	2.481	5/24/2018
10Y T-bond WS0428	7/12/2018	900	3.210	5/24/2018
30Y T-bond WS0447	7/12/2018	150	3.395	4/27/2018

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



Comment

Unchanged (no surprises at all). Next week brings two opportunities to move the index, both on Monday. One is the PMI and the second is flash CPI.

* 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 4.8%. 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, rather benign external environment and stimulation on all fronts.
- Inflation turned around and is set to breach 2% in the summer, before dropping back towards 1.5% towards year end. The key driver are fuel prices and stronger US dollar. Food prices set to decelerate further this year. Those looking for a durable rise in inflation should take a look at core consumer goods (where there is a multi-year upward trend) and services. The pass-through from higher wages has thus far been limited, by we continue to put faith in this time-tested relationship.
- MPC stays calm and waves away any signs of intensifying wage pressure. In our view, as long as inflation stays within the target band, the MPC will keep its rhetoric in place. Weaker PLN has likely no impact on the MPC's discussions, since pass-through effect are seen as negligible. Our current forecast reflects this reality – no change in interest rates until Q4 2019.
- Fiscal situation continues to be very comfortable. 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. The impact of PLN-specific factors on the currency has been relatively small.
- Our scenario of an upward correction in EURPLN has finally materialized. Hawkish Fed concerns, inflation scare, EM asset sell-off and very dovish MPC both contributed to a notable depreciation in the PLN (more than 5%). It seems that the PLN, negatively impacted by easy monetary policy, can only catch a reprieve if global rates move sharply lower and investors readjust their expectations regarding the global economy and global monetary policy in a wholesale fashion.
- Thus, we believe that stronger PLN can only be expected over the medium term. In the coming months PLN is set to depreciate further. In addition, weaker PLN will act as a pressure valve on exporters' margins squeezed by rapidly rising labor and commodity costs.

mBank forecasts

	2014	2015	2016	2017	2018 F	2019 F
GDP y/y (%)	3.3	3.8	3.0	4.6	4.8	4.0
CPI Inflation y/y (average %)	-0.1	-0.9	-0.6	2.0	1.6	2.7
Current account (%GDP)	-2.1	-0.6	-0.3	0.3	-0.2	-0.6
Unemployment rate (end of period %)	11.4	9.8	8.2	6.6	5.5	5.0
Repo rate (end of period %)	2.00	1.50	1.50	1.50	1.50	1.75

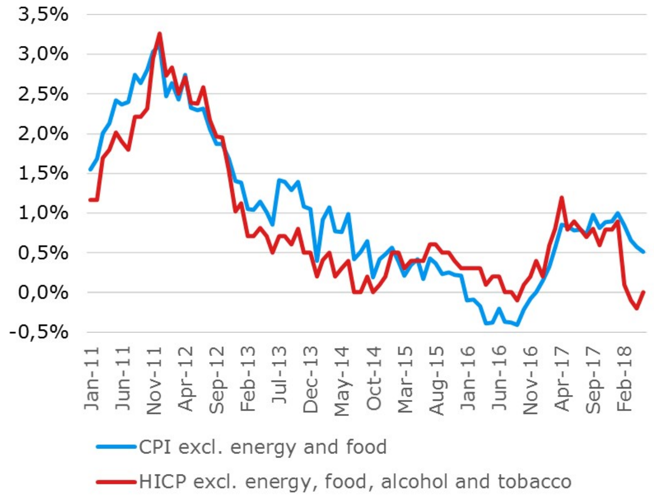
	2018 Q1	2018 Q2 F	2018 Q3 F	2018 Q4 F	2019 Q1 F	2019 Q2 F	2019 Q3 F	2019 Q4 F
GDP y/y (%)	5.2	5.2	4.7	4.4	4.2	4.2	4.0	3.7
Individual consumption y/y (%)	4.8	4.8	4.6	4.2	4.0	3.8	3.8	3.8
Public Consumption y/y (%)	3.6	3.0	4.0	4.0	2.0	2.0	2.0	2.0
Investment y/y (%)	8.1	10.0	10.0	8.0	7.0	6.0	5.0	4.0
Inflation rate (% average)	1.5	1.7	1.8	1.4	1.9	2.3	2.4	2.6
Unemployment rate (% eop)	6.6	5.7	5.5	5.5	5.7	4.9	4.8	5.0
NBP repo rate (% eop)	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75
Wibor 3M (% eop)	1.70	1.70	1.71	1.72	1.73	1.73	1.73	1.98
2Y Polish bond yields (% eop)	1.49	1.55	1.55	1.60	1.65	1.85	2.00	2.20
10Y Polish bond yields (% eop)	3.18	3.30	3.35	3.40	3.50	3.59	3.71	3.88
EUR/PLN (eop)	4.21	4.36	4.42	4.40	4.30	4.20	4.10	4.05
USD/PLN (eop)	3.42	3.76	3.78	3.73	3.60	3.47	3.35	3.27

F - forecast

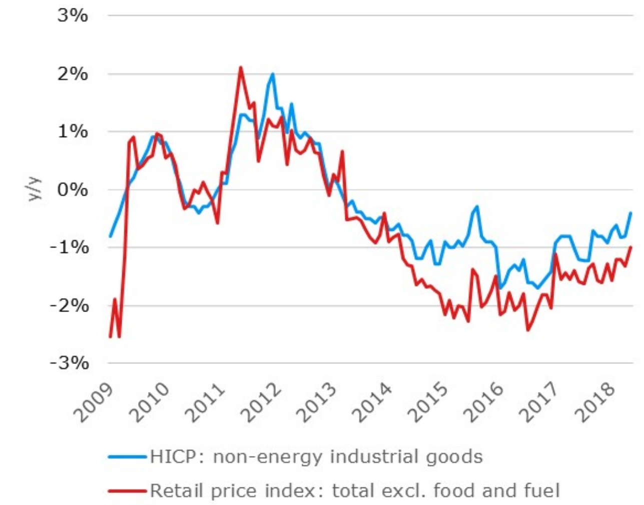
Economics

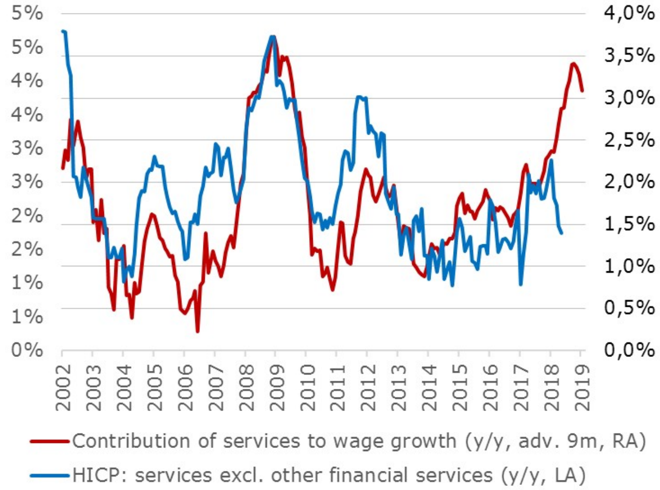
The Incredible Shrinking Core Inflation

Much has already been said about the surprising decline in core inflation in Poland. Compared to optimistic forecasts (including ours) assuming a nearly linear path upwards this year, actual data have shown a considerable decline. At present, core CPI is 0.5% y/y (down from 0.9% y/y in January) and core HICP is precisely 0% y/y (down from 0.9% y/y in January). The levels are, needless to say, also inconsistent with historical relationships between labor market slack, output gap, wage growth and core inflation. Thus, it is of utmost importance to look into the details of Polish inflation and assess the reasons for this year's disappointments.



The paths of non-core items are generally uncontroversial: fuel prices will push headline inflation above 2% in the summer – afterwards base effects become unfavorable; food prices will continue to decelerate this year as base effects and very favorable local weather conditions are working in tandem. Within core inflation, we usually distinguish between core goods and core services. The former has long remained in deflation (as opposed to the previous cycles), but there is a mild upward trend consistent with global tendency. It is likely that both PLN depreciation and higher commodity prices are pushing this category slowly upwards.





However, core goods are not the category that has been considered as the best candidate for generating meaningful inflationary pressures in Poland – services have. Due to the decisive role of labor in service producers' cost structures, the impact of wage growth on services prices has always been extremely strong, albeit the relationship works with a clean, ca. 9-month lag. Given the acceleration in wages in 2017 and at the beginning of 2018, much faster services inflation seemed baked in for this year. Services prices (HICP measure) decelerated from 2.6% y/y in January to an all-time low of 0.3% y/y in May. The depth of the crash is somewhat misleading because of the puzzling behavior of financial services prices we have already covered several weeks ago, but the deceleration is not driven by one factor. On the contrary – even if other big-ticket items (like car insurance and package holidays) are excluded, the pattern is unchanged. Services price growth peaked at the turn of the year and has been drifting lower since then. This pertains to categories as different from each other as repair of clothing, maintenance and repair of household appliances, dentistry services and hairdressers.

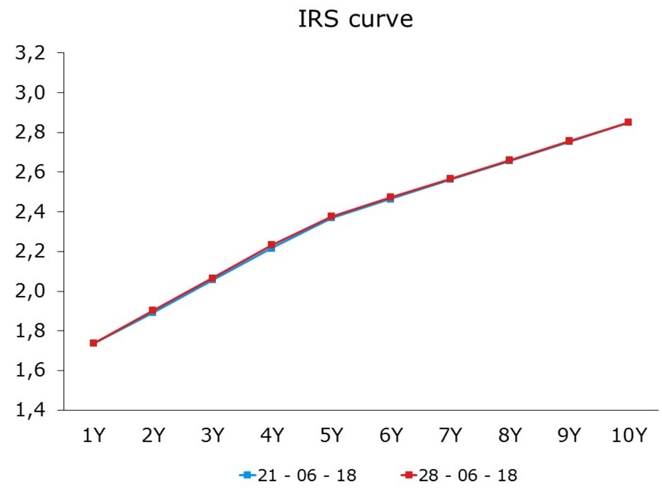
Therefore, it seems that the inflationary impulse seen in late 2017 is waning, at least in services. Attribution of the reasons for this is a far more difficult matter and several hypotheses can be formulated: higher competition, overstatement of wage pressure in corporate sector statistics (with the added impact of immigration), well-anchored inflation expectations and large productivity gains. For now, we are both skeptical and agnostic with regard to all of the above. It would be premature to declare the relationship between wages and services prices as dead. One should wait for the second half of this year – when the predicted impact of higher wages is set to be the strongest – to see it tested. Market-wise, it seems that expectations regarding core inflation in Poland are close to bottom and upward surprises are therefore more likely.

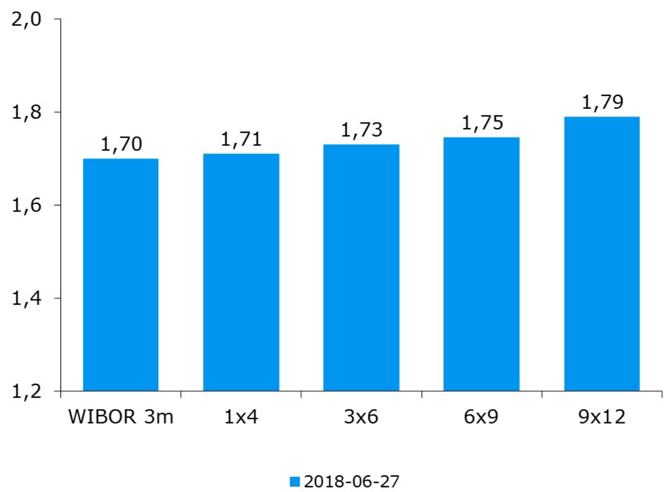
Fixed income

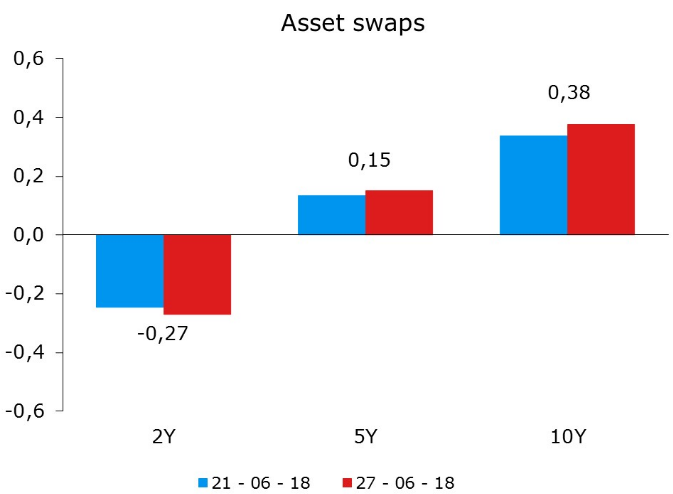
Negative net supply, again

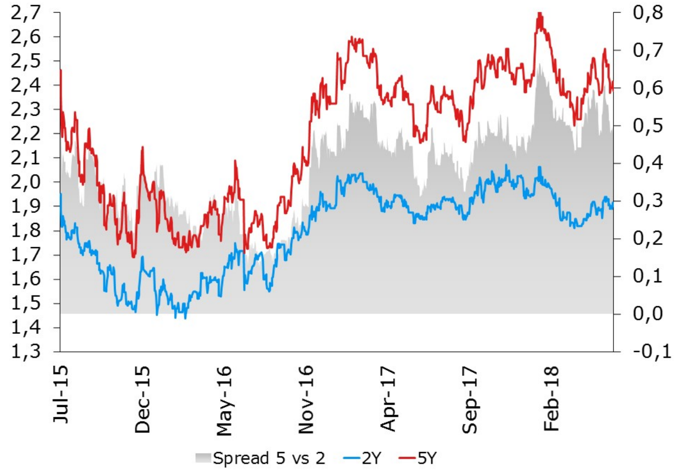
Second auction in June was canceled. Supply in Poland will be limited during holidays. We have seen some flow on ASW, and as a result the spreads are really wide (especially DS0726/8y, at 38bps). In July we will see a huge cash inflow into the POLGB market, PS0718 plus coupons, PLN 17.1 bn total.

PS0123/5y is -2 bps, WS0428/10y is 31 bps. PS0123/WS0428 is 82 bps. WS0428/Bund is 291 bps. PS0420 is trading at 1.57% (1 bps up), PS0123 is trading at 2.39% (4 bps up) and WS0428 is trading at 3.21% (7 bps up).









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Money market

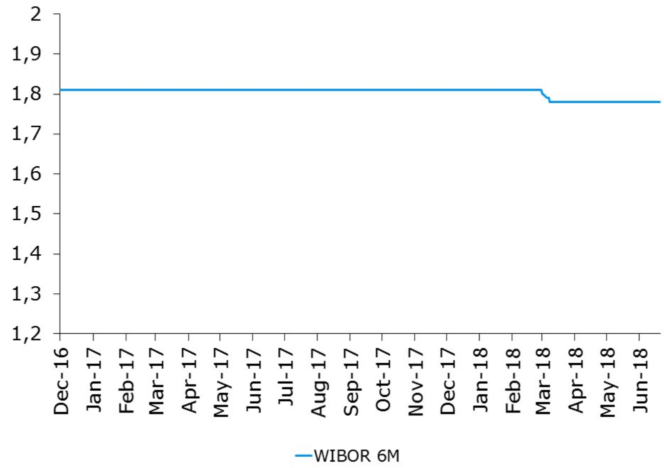
Tight range

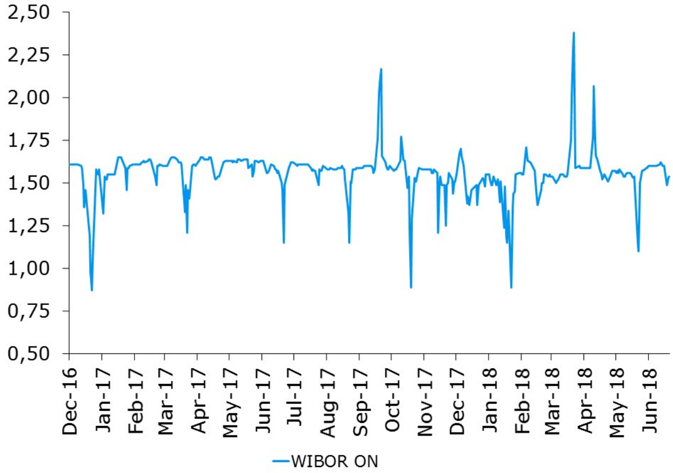
Polish market is stuck in a tight range not responding to any global developments. We are currently at levels which we perceive as the midpoint for the current range. Therefore, investors will likely stay aside and wait for a move towards the range band. Next week we have a CPI report – any divergence from market consensus may push the market in either direction.

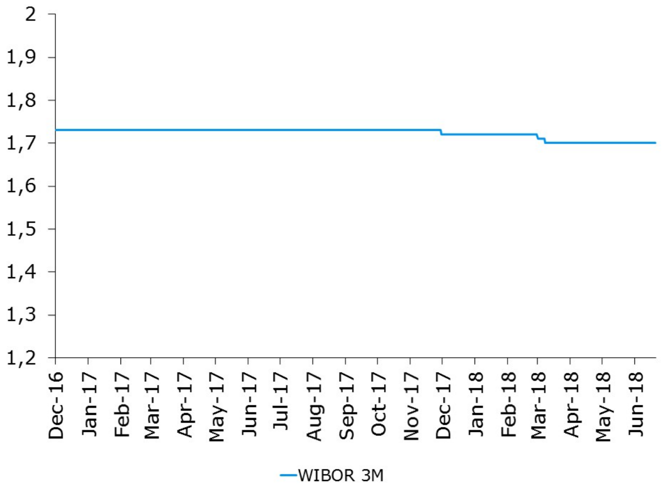
End of the month brings limited activity and liquidity on the money market. Spreads have widened, but everything should get back to normal next week.

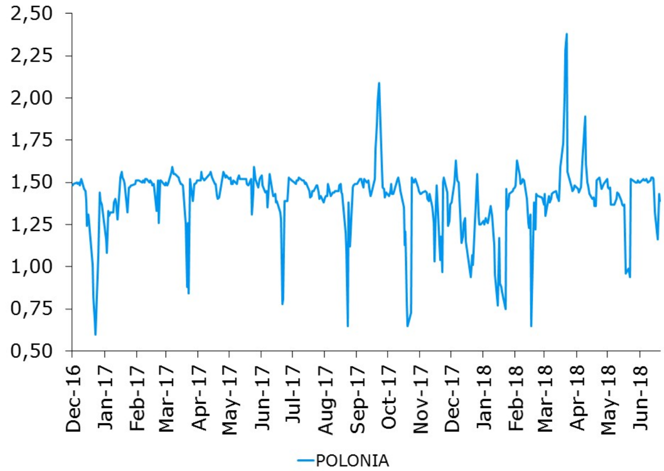
Ref rate vs Polonia averages:

30 day 5 bps
90 day 5 bps





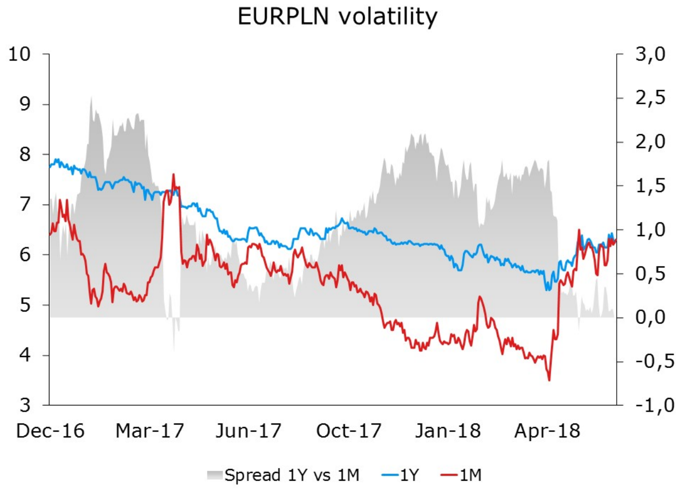




Forex

Spot – EUR/PLN spiked through 4.35 PLN is on fire. EUR/PLN is based above the 4.30 support, touching 4.3080 briefly (5 trading sessions low). From there, the ascend begun and EUR/PLN reached 4.3710 high as a result. It gives a strong technical signal and paves the way for 4.39/4.40 – the next resistance zone. The reasons behind the move are mostly external with global risk sentiment being the first to blame. We would expect the PLN losses to at least slow their pace in the near future. A new range is yet to be defined, but 4.33-4.39 seems likely.

Options – Volatility higher The volatility was drifting lower until EUR/PLN spot breached 4.35. With the PLN basket (equally weighted EUR and USD) at the YTD low, the demand for vols re-emerged. There was a trade in 1 month EUR/PLN at 6.4% in the good amount, and at 6.25% in 1 year. The 1 year RR 25d traded at 1.3%. In the end, 1 month EUR/PLN mid fixed at 6.6% (0.2% higher), 3 months are at 6.4% (unchanged) and 1 year is 6.4% (0.05% lower). The skew is roughly unchanged.



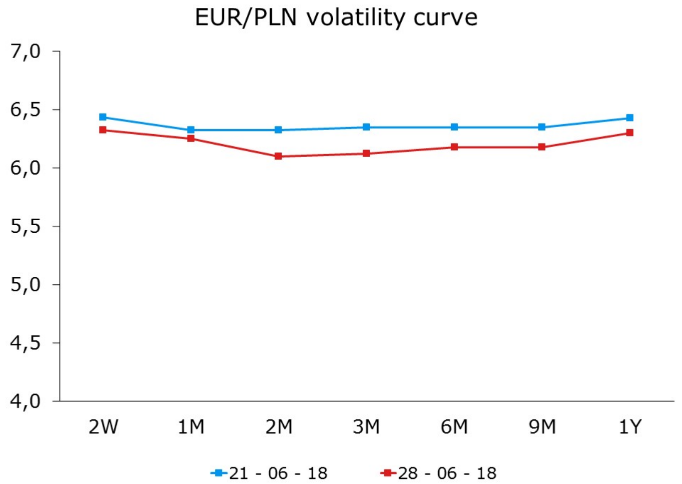
Short-term forecasts

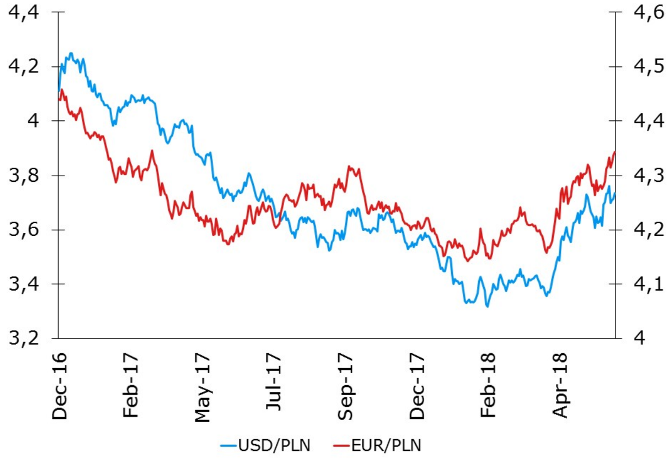
Main supports / resistances:
EUR/PLN: 4.3200 / 4.3900
USD/PLN: 3.6000 / 3.9000

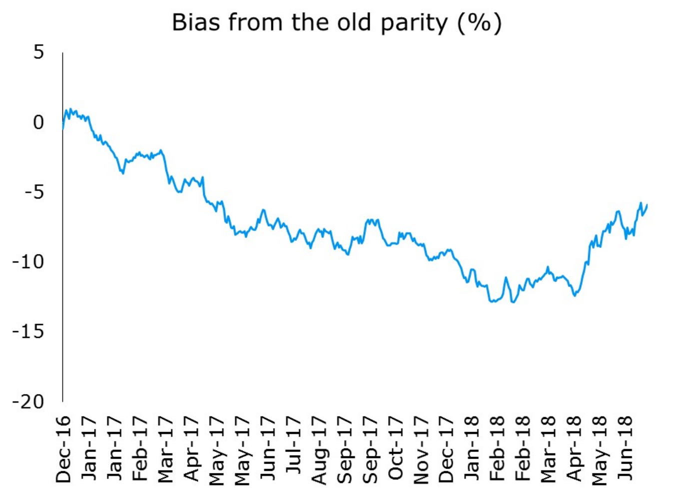
Spot Current position: None.

Our short EUR/PLN from 4.3050 and 4.33 was stopped at 4.3500.

The price action is to be respected, the stop was triggered and we are now back to a more flexible approach. Being aware of the rangy nature of EUR/PLN, we will be trying to play the still theoretical 4.32-4.39 range, preferably from the long PLN side.







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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
6/21/2018	1.93	1.70	2.03	1.68	2.07	1.72	1.71	1.73	1.75	1.78	1.84	1.82
6/24/2018	1.86	1.70	1.97	1.68	2.00	1.72	1.71	1.72	1.75	1.79	1.84	1.83
6/25/2018	1.93	1.70	2.04	1.68	2.07	1.72	1.71	1.73	1.75	1.79	1.86	1.82
6/26/2018	1.75	1.70	1.85	1.68	1.90	1.72	1.71	1.74	1.76	1.81	1.84	1.85
6/27/2018	1.85	1.70	1.99	1.68	1.99	1.72	1.71	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
OK0720	5/24/2018	7/25/2020	96.55	1.64	20	122	22
PS0123	5/24/2018	1/25/2023	100.07	2.48	1400	2440	1389
WS0428	5/24/2018	4/25/2028	96.11	3.21	900	1495	865

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0720	5Y IRS	PS0423	10Y IRS	WS0428
6/21/2018	1.720	1.373	1.890	1.644	2.368	2.502	2.850	3.187
6/24/2018	1.720	1.364	1.900	1.635	2.388	2.507	2.875	3.168
6/25/2018	1.720	1.359	1.890	1.635	2.388	2.505	2.870	3.183
6/26/2018	1.720	1.357	1.918	1.638	2.415	2.541	2.893	3.251
6/27/2018	1.720	1.357	1.900	1.629	2.377	2.528	2.850	3.226

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
6/21/2018	6.33	6.35	6.35	6.43	6.43	1.44	0.51
6/24/2018	6.20	6.18	6.28	6.30	6.30	1.44	0.51
6/25/2018	6.25	6.10	6.18	6.25	6.25	1.45	0.55
6/26/2018	6.30	6.15	6.18	6.30	6.30	1.45	0.55
6/27/2018	6.25	6.13	6.18	6.30	6.30	1.43	0.54

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/21/2018	4.3323	3.7607	3.7726	3.4046	1.3282	0.1669
6/24/2018	4.3149	3.6977	3.7367	3.3571	1.3296	0.1675
6/25/2018	4.3242	3.7087	3.7567	3.3882	1.3316	0.1675
6/26/2018	4.3372	3.7151	3.7595	3.3883	1.3320	0.1674
6/27/2018	4.3430	3.7351	3.7669	3.4024	1.3271	0.1676

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