HISTORY

Positive Trends and Political Challenges in Poland

July 21, 2016

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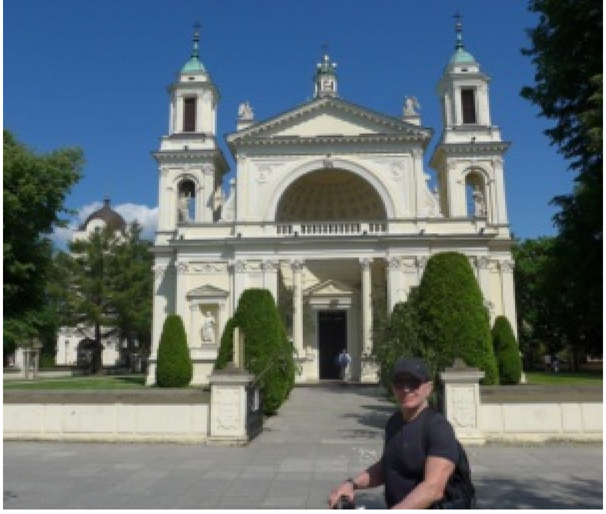
My first visit to Poland was in 1991, just as the country was emerging from its Communist era. In those days, Warsaw was a dreary city with empty store windows and shops with nothing much to sell. Located in the heart of the city, its tallest building was (and still is) the 231-meter tall "Palace of Culture and Science in the name of Joseph Stalin," a gift from the Soviet Union (Stalin's name was later removed). Many say the striking building—patterned after similar buildings in Moscow with gothic towers topped with elaborately decorated spires and huge statues—resembles a wedding cake. Warsaw today is a lively, modern city with many skyscrapers dotting the skyline and many amenities for residents and visitors, including a number of familiar hotel chains, coffee shops, restaurants and retail stores.

Poland's Palace of Culture and Science

Poland has been one of Europe's fastest-growing economies in recent years; gross domestic product (GDP) growth was 3.6% in 2015 and is expected to rise a similar amount in 2016.[1] Poland's labor market has been improving and wages have been rising, spurring household spending. The unemployment rate has fallen to lows not seen since 2008, and the government has introduced subsidies for families with children, which could offer more impetus to consumer spending. The emphasis on childcare and education is evident everywhere. In one shopping mall I visited during my recent travels to Poland, I noticed there was an educational/play area for children on each floor; one had giant puzzle pieces that children could figure out how to fit together, while another had a display of prehistoric life with models of dinosaurs the children could play with.



Cycling along the outskirts of Warsaw

While the global markets reflected shock after the people of the United Kingdom voted to leave the European Union (EU) in June, I think there could be a silver lining for Poland and other emerging markets in Europe from the Brexit decision. New trade barriers could cause some companies based in the United Kingdom—particularly in the area of manufacturing—to move to countries which are still part of the EU and may offer more favorable agreements and lower-cost labor, such as Poland, Hungary and the Czech Republic. For Polish people living and working in the United Kingdom, the future is a bit uncertain amid anti-immigration rhetoric from those supporting the United Kingdom's "Leave" campaign. It has been estimated that these workers send roughly US$1 billion (€0.9 billion) back to Poland each year.[2]

The Rise of Polish Nationalism

A potential Brexit outcome that worries me generally speaking is a possible retrenchment in global trade and reform efforts worldwide. Poland's political environment has become clouded with the rise of the ruling nationalist Law and Justice Party headed by Jaroslaw Kaczynski. Kaczynski is the twin brother of Poland's previous president, who died in 2010 in a plane crash when landing in Smolensk, Russia. Poland's people are very proud and protective of their independence and identity, and nationalism has intensified under the Law and Justice Party's rule. This rise in nationalism is not unique to Poland—the Brexit outcome being a very visible sign of its spread. A rise in nationalistic sentiment can come with a troublesome retrenchment in global trade, and an isolationist stance on the part of politicians can result in avoidance of reforms that bring more growth-oriented policies and privatization efforts. This is of concern to us.

A Selfie in Sopot, Poland

A Polish newspaper poll I read found 55% of respondents believed Kaczynski actually ran the country, even though he doesn't hold an official government office. He is depicted as promoting skepticism and deep mistrust of Poland's neighbors and former occupiers. The new government has also been accused of taking control of public media, the intelligence services and its highest court. Kaczynski's strident nationalism could stem from the history that shaped his youth. At the end of World War II, 85% of the buildings in Warsaw had been destroyed, and Kaczynski grew up learning about the horrors of Moscow's suppression and imposition of communism. He and his brother worked with Lech Walesa, the Solidarity trade union chief who helped bring down the Communist party in Poland. The death of his twin brother still seems to weigh heavily on Kaczynski, as he reportedly visits his brother's grave every Saturday as well as at other times to mark key events.

Evidence of Poland's increasing nationalistic stance can be found in the government's suspension of privatization efforts involving companies in the banking, insurance and energy sectors considered to be strategically important. We would argue privatization efforts had been a key component to the Polish economy's previous success. The government also revised public procurement rules to favor local companies, something that would likely concern other EU-member countries. In an effort to protect Poland's important coal mining sector, the government also loosened the energy policy regarding carbon emission levels.

Poland's new government has proposed measures to bolster government finances by introducing a new tax on bank assets as well as a loan conversion program for Swiss-franc-denominated loans that will force banks to convert these loans into Polish zloty. With more than 500,000 Polish households estimated to be holding such loans, the conversion program, together with the new bank levy, is likely to be costly for the banking industry. Years ago, many banks offered clients mortgages in Swiss francs, which were attractive to home buyers because of the very low interest rates. At that time, we thought this was a mistake and warned that such a practice for clients whose earnings were only in Polish zloty would be dangerous if the exchange rate changed. Sure enough, the zloty devalued against the Swiss franc and many homeowners were in trouble. Unable to make payments, many people lost their homes. It thus became popular for the government to favor the mortgage-holding public and hit the banks with measures to take the risk.

Additionally, Poland unveiled a sweeping pension-reform plan aimed at dismantling the privately owned pension fund system and transferring the bulk of assets to individual retirement accounts, a portion of which will be managed by a state entity. The European Commission put Poland on watch over the plan, stressing member-state pension systems should be "adequate, safe and sustainable." There is concern that some long-term pension assets could be used to finance certain government agendas.

Strength of the zloty is certainly a concern to us as investors in Poland, and another big overarching issue is the refugee crisis in Europe. Although Poland's previous government had agreed to accept 7,000 refugees under the EU's refugee redistribution quota, the new government has been strongly critical of this move—rather ironic as many Poles working in the United Kingdom are now worried they may be forced to come home.

Sopot, Poland

Recently, the European Commission has expressed concern about some practices in Poland, including what it cited as a lack of respect for the "rule of law" as well as new media laws that give the government authority to appoint and dismiss key television and radio directors at publicly financed media outlets, which could limit freedom of expression. Since Poland joined the EU in 2004, the country has benefited from billions of euros in grants and loans to improve the infrastructure. So, ties to the EU remain important for Poland. Recently, the EU has been allocating funds to support innovation in Poland and boost competitiveness. In 2015, the European Commission adopted the 2014–2020 Operational Programme "Smart Growth" of Poland, worth €8.6 billion of investments to improve economic growth.[3] It emphasizes strengthening research and development activity and enhancing small- and medium-enterprise companies to develop new ideas and competitive advantages. As if to allay EU concerns, the new government vowed to remain committed to adhering to the EU's fiscal rules (maintaining fiscal deficit below 3% of GDP and debt below 60% of GDP).

The political environment has caused some concerns among rating agencies. In January 2016, Standard & Poor's (S&P) downgraded the country's debt, and in May of 2016, Moody's Investors Service shifted Poland's sovereign rating outlook to Negative from Stable, while keeping the long-term rating at A2. On July 15, Fitch agency affirmed Poland's credit rating at A-, an unchanged level. In its press release justifying the decision, Fitch Ratings highlighted the solid macro fundamentals of the Polish economy reflected in strong GDP figures.[4] The agency forecasts GDP growth at the level of 3.2%-3.3% in the years 2016-2018, which it says should be supported mainly by private consumption.[5]

Bottom-Up Investment Opportunities in Poland

While the political environment presents broad challenges, as bottom-up investors it's our job to find individual companies able to survive and thrive in any given environment. We had the opportunity to visit a number of companies in Poland this spring, and we noticed five interesting trends in the economy that gave us room for optimism as investors:

1. The rapid growth of the consumer market
2. Substantial improvements in infrastructure, with better roads encouraging more car and truck transport
3. An increasing emphasis on technology and investment to improve quality
4. Tighter bank credit as a result of government policies regarding the banks
5. The growing internationalization of Polish business with many companies expanding into the rest of Europe and even beyond

For one of our first company visits in Poland, we met with managers of a car rental company specializing in auto-fleet management. The business touches on the aforementioned themes of both the rapid growth of the consumer market as well as infrastructure. The managers there told us that only about 10% of companies in Poland with 500 or more employees use car fleet-management services, while in Western Europe the figure is close to 50%. Many of the individuals who had leased their cars wound up purchasing them. So, the potential for growth in this area looked good.

We also visited one of the largest oil refiners in the region. The State Treasury has a large stake in the company, but its shares are listed on Poland's stock exchange and held by a variety of local and foreign investors. The company is a good example of successful privatization of a state enterprise that has gone beyond its own border and has taken advantage of the opportunities in the EU.

Another company we visited had an innovative technology for infrared detectors which can be applied in multiple sectors (army, railways, automotive, air quality detection, medicine). The company had a strategy to reduce the average price per detector and significantly increase volumes and the accessibility and popularity of the technology in new industries. One interesting application was to check the temperature of machine parts to detect faulty elements in any machine (a faulty part would have higher temperatures). Another application is in medicine, to detect inflammatory states in human tissue that can be cancer markers.

We also visited a small but innovative bank that was interested in acquiring other banks in order to extract cost and revenue synergies. As an example of the impact of EU integration, the bank was launched in 2008 by an Italy-based conglomerate. Officials cited their big challenge has been the new banking tax, a third of which will have to be directly absorbed by the bank, as Poland's government strongly stated that it would not allow banks to pass on banking tax costs entirely to customers.

A restaurant operator we visited was expanding into other countries in Eastern Europe as well as to Spain and even China. The management said that they saw strong growth potential given the government's populist measures to put money in the hands of households.

Also in the consumer space, we visited a major furniture manufacturer in Poland. The Polish furniture industry has a strong tradition; Poland is the third-largest furniture-producing country in Europe and fourth-largest in the world in export sales, with furniture exports representing about 2% of Poland's GDP.[6] The niche of the company we visited was ready-to-assemble furniture. As we toured the company's factory and warehouse, we were impressed with its modern facilities and advanced equipment. Interestingly, one of their major customers is a South African group we were quite familiar with.

The company pointed to EU pollution regulations as a consideration for their business. More European customers are seeking furniture without harmful substances, and the company aimed to meet that demand with new particle board produced without formaldehyde. We asked about Chinese competition in the furniture industry but the company officials told us ordering from Chinese manufacturers usually took about three months for delivery, and they could deliver in about half that time. Additionally, they told us Chinese producers were not as price competitive as they had been in the past.

The Polish people love celebrations, and traditionally beer and vodka have been the mainstays of such events. We visited a producer of vodka and other spirits, including bitters, brandy and rum. Citing limited growth prospects in Poland and the Czech Republic, the managers told us they are looking to make acquisitions in other areas of Europe and around the world, another example of how Polish companies are spreading their wings internationally.

We hope that Poland's leadership recognizes the need for continued reform and that its nationalistic sentiment does not come at the expense of growth, global trade and innovation. We think Poland is at an exciting period of its history with many challenges but also with more opportunities for investors. We look forward to exploring more potential opportunities in the country.

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1. Source: IMF World Economic Outlook database, April 2016. There is no assurance that any estimate, forecast or projection will be realized.

2. Source: Central Bank of Poland; data on remittances as of 2013.

3. Source: "EU will invest €8.6 billion of regional funds in Poland to boost innovation," European Commission press release, February 2015.

4. Source: Fitch Ratings press release, July 15, 2016.

5. There is no assurance that any projection, estimate or forecast will be realized.

6. Source: Eurostat, 2015 data.

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