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Comment on the upcoming data and forecasts

On Tuesday Statistical Office will publish labor market data and on Wednesday industrial data. We expect drop of employment in manufacturing. EURO2012 effect should be minimal as the statistics are made among enterprises of more than 9 employees, but could stem annual growth rate drop below zero. Wages in May were boosted by increases in refineries and overtime hours before football tournament, but the downtrend is on the cards. What is more, in June in minus acted one working day less than in 2011 and lack of bonuses in mining. Our optimistic (compared to market consensus) industrial production forecast is based on low statistical base from 2011 (+ 4-5pp). In minus acted one working day less and high base from May on food and beverages category (-2.3pp). Lower PPI growth comes from significant correction on commodity prices with only little change in zloty valuation. Core prices in manufacturing remain stable. On Friday NBP will publish core CPI - our calculations from headline CPI data confirm our forecast of 2.3% y/y.

Polish data to watch: July 16th to July 20th

Publication	Date	Period	BRE	Consensus	Prior
Employment y/y (%)	17.07.	June	0,2	0,2	0,3
Average gross wages y/y (%)	17.07.	June	1,8	3,5	3,8
PPI y/y (%)	18.07.	June	4,4	4,7	5,0
Industrial production y/y (%)	18.07.	June	5,4	3,8	4,6
Construction y/y (%)	18.07.	June	2,2	4,5	6,6
Core CPI y/y (%)	20.07.	June	2,3	2,5	2,3

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Last yield (%)	Prev auction
52 Week T-bills	-	3000	4.470	3/26/2012
2Y T-bond OK0714	7/19/2012	7500	4.759	4/19/2012
5Y T-bond PS0417	7/19/2012	4800	4.784	6/20/2012
10Y T-bond DS1021	7/11/2012	4000	5.349	5/10/2012
20Y T-bond WS0429	7/11/2012	4000	5.563	5/10/2012

Macroeconomic forecasts

Wskaźnik	2009	2010	2011	2012 F	2013 F
GDP y/y (%)	1.7	3.8	4.3	2.5	2.1
CPI Inflation y/y (average %)	3.5	2.8	4.2	3.6	2.8
Current account (%GDP)	-1.6	-4.5	-4.9	-2.5	-1.5
Unemployment rate (end of period %)	12.1	12.4	12.5	13.5	14.4
Repo rate (end of period %)	3.5	3.5	4.5	4.5	3.75

	2011 Q3	2011 Q4	2012 Q1	2012 Q2 F	2012 Q3 F	2012 Q4 F
GDP y/y (%)	4.2	4.3	3.5	3.0	2.5	1.4
CPI Inflation y/y (average %)	4.1	4.6	3.9	4.1	3.8	3.2
Repo rate (end of period %)	4.50	4.50	4.50	4.75	4.75	4.50

F - forecast

Economics

Inflation accelerates in June, yet not due to EURO 2012 (but... potatoes)

In June CPI inflation grew to 4.3% y/y from 3.6% in May. Apart from base effects, this acceleration resulted from growing food prices (0.7% m/m), and was in particular due to more expensive vegetables; the prices of potatoes grew at a pace far above 50% (which resembles the pattern recently observed in the Czech economy). Interestingly, there was virtually no effect of growing prices at hotels and restaurants due to hosting EURO 2012, as opposed to the previous media coverage of the topic. This category grew by sole 0.4% m/m. Prices remained stable in the other base categories. Core inflation stayed unchanged as compared to May, at 2.3% y/y.

Passing to prospects for the following months, we only see the room for small reduction in inflation rate after correcting for a sharp increase in the prices of potatoes, and it should remain above 4%. Yet a clear reduction in CPI dynamics will not take place until October. At the end of the year, inflation should decrease to approximately 3%. This outlook (taken also into consideration in the NBP's Inflation Report), along with deteriorating data from the real economy ,should result in monetary policy easing. We see November as a probable date of a rate cut (already after a sequence of weak macro readings). The size of easing will probably resemble the one from the previous cycles. Shall the MPC already decide to ease and - at the same time - challenge the sense of its previous hike decision, small-size movements would not make much sense either then. The easing cycle should be further supported during the last quarter of 2012 by subsequent data flow - we expect the GDP growth to slow down in q4 to 1,4% y/y.

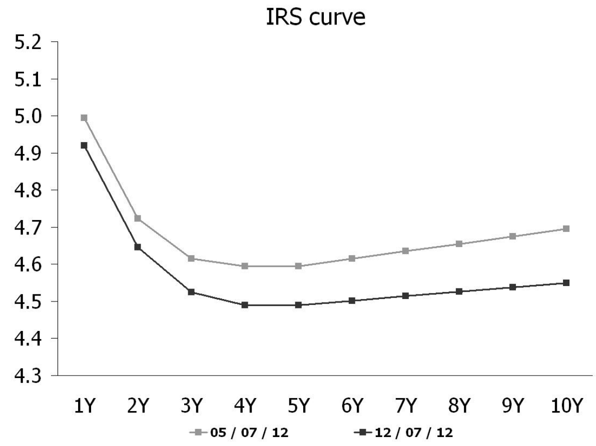
Accelerating inflation has not caused any growth in market rates. Part of the investors feared much higher acceleration, others do not find any more courage to fight against the global trend of lower rates.

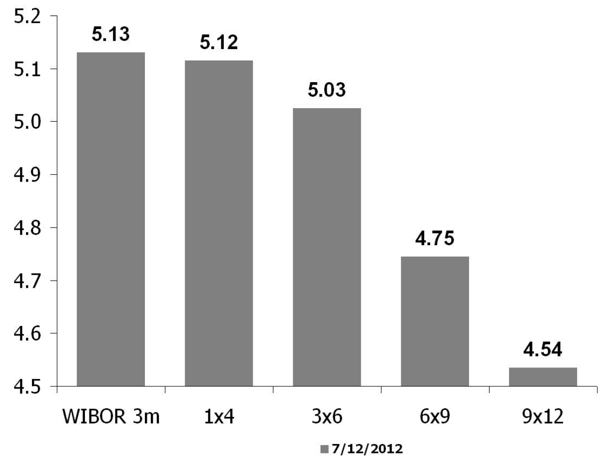
Fixed income

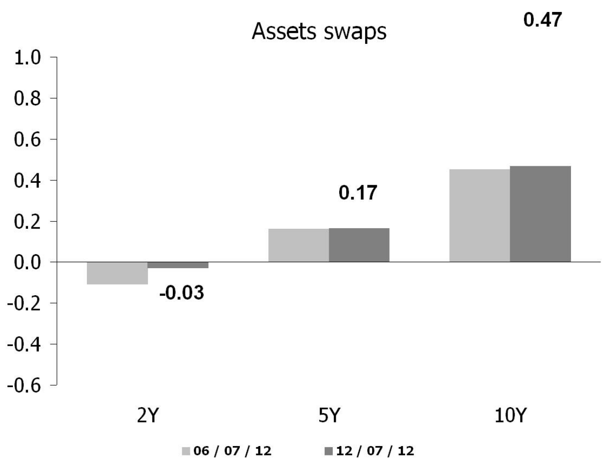
CPI limits scope for further rally

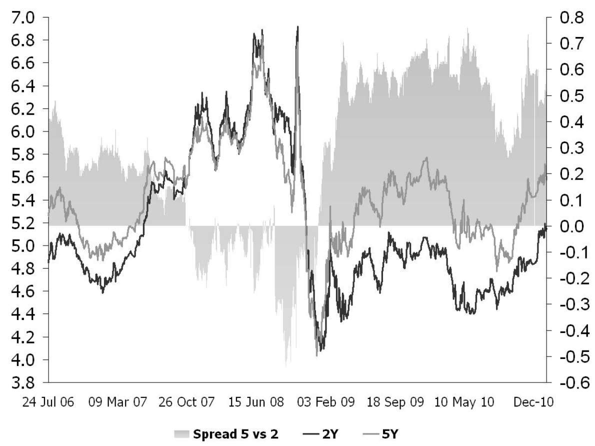
It's been one of the strongest rallies we've seen on Polish FI market for quite a while. Demand for POLGBs seemed to be getting stronger every day and yields, especially in the long end of the curve plunged below 5%, levels not seen since 2006. Swap rates also moved down by approximately 15bp. Comments from MPC members were surprisingly supportive, both Chojna-Duch and Bratkowski signalled readiness to lower NBP rates soon, even by more than 25bp already in September. Of course it's still only two council members and ones being minority for quite a while already. Other comments weren't so skewed towards dovishness, nevertheless 'not seeing room for a rate cut for now' is already quite a shift after a hike that happened just two months ago.

At the moment market is pricing in a full, 100bp cutting cycle within 12 months time. What is quite surprising, is the continuous flattening of already inverted 2y5y curve. Normally we would rather expect cuts being priced in rather sooner than later and then positive forward curve further donwards. Market has definitely reached a point, where further rally would require support either from macro data or dovish rate setters. Yet CPI figure didn't help the market. 4.3% y/y is definitely still too elevated to allow policy easing soon enough for what forwards are implying to materialize. Therefore we would expect some sort of correction from current levels. In the medium term however, direction for rates is still set. Such a correction would only create opportunity to enter receive positions again.









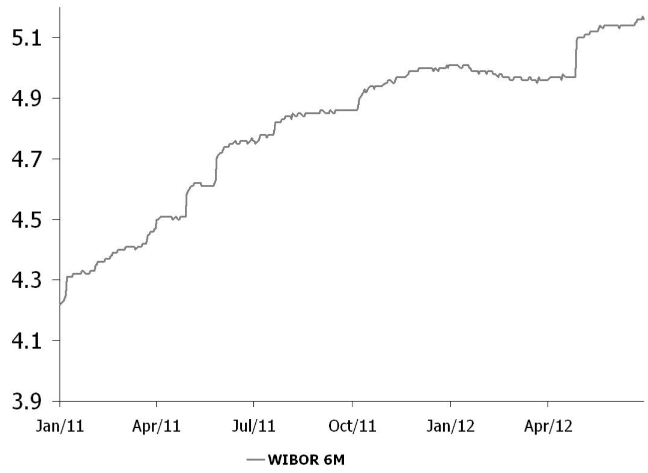
Money market

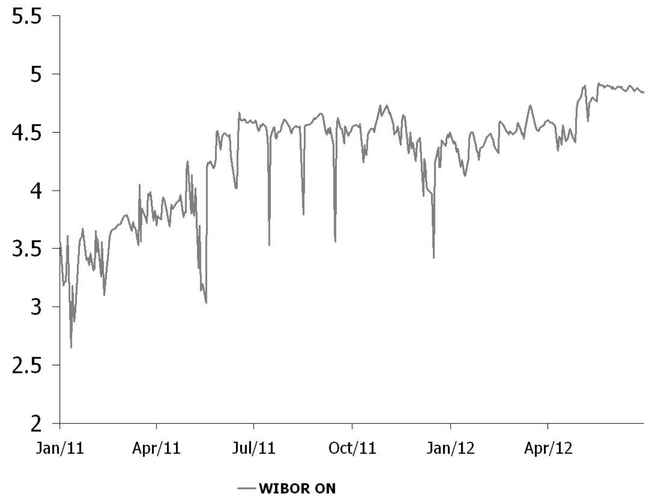
Expensive cost of carry Cost of carry very high taking into consideration huge surplus of the cash last week. Next week is not going to be better since today the market bought 97.5 billion pln of money bills, which indicates the shortage.

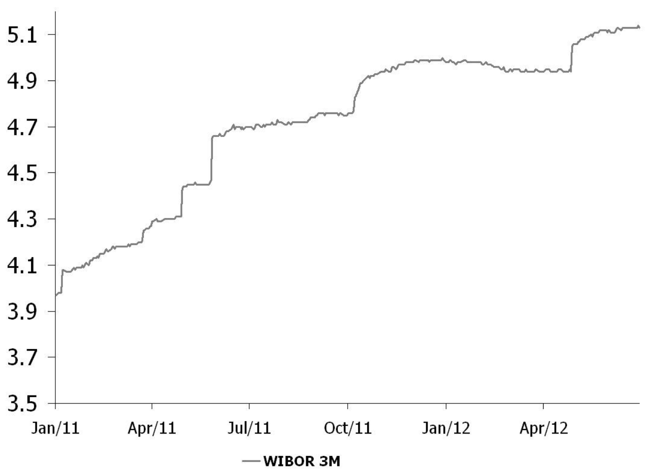
Higher CPI reading. Higher CPI reading (4.3% vs 4.1% expected) should stop the bullish explosion and expectations for rate cuts as soon as September/October. We think that the most probable scenario is for the rates on hold this year.

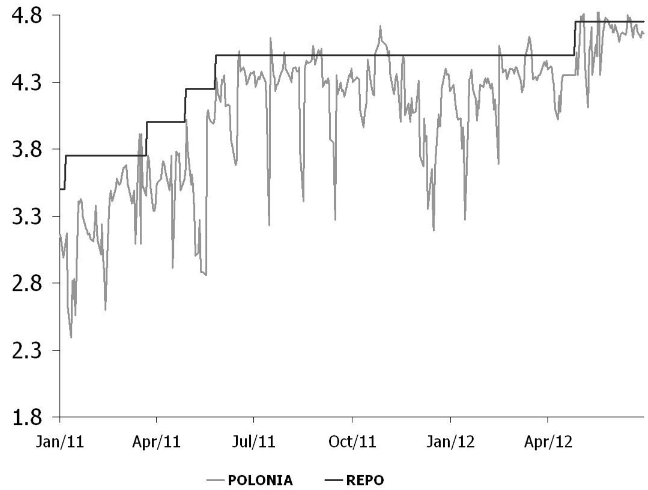
Interbank market ceases to exist due to excessive interventions of the central bank. We see the concern from the NBP and KNF sides referring to a dramatically falling turnover on the cash market. The turnover on the polonia index (based on real overnight trades) dropped even below 500 million pln a day, which is next to nothing. In our opinion this is a pure derivative of the excessive interventions of the central bank in their chase to stabilise the polonia index. As we were many times pointing out this is a pointless goal (written down in the assumptions to the monetary policy), now this is also a very harmful goal. The polonia index is just used by banks and has no influence on any other market parameters (ex wibor). Therefore, this is not a canal for the monetary policy interaction. Reaching this goal and sacrificing the liquidity of the interbank market is a huge mistake.

Conclusions. Now some constructive suggestions. The smartest thing to do would be: removing the point about polonia index stabilization (this would bring back the liquidity to the interbank market since the central bank would have no pressure to intervene out of the regular operations); implementing 3M repo operations (this would be the best benchmark for the 3M wibor, which is the most important market indicator for the economy, as vast majority of the loans is based upon it, hence this is the correct canal for the monetary policy interaction).





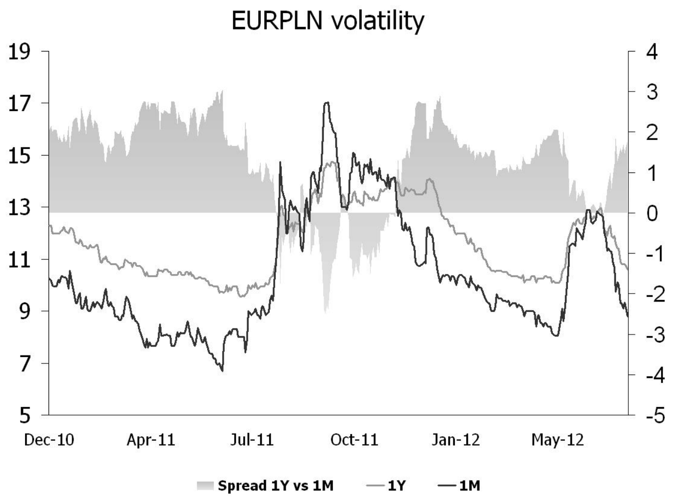




Forex

Zloty stronger. Following sharp selloff last week, EUR/USD extended losses to 2yr lows (1.2165 on Thursday), but it didn't prevent the Zloty from getting stronger. During the first two days of the week zloty rose over 1.9 percent against the Euro, hitting a 2-month high 4.1620, fuelled by foreign investors' demand for Polish bonds. Finally on Thursday the strong EUR/USD losses did put a squeeze on recent EUR/PLN shorts, but given the long slide down from the early June tops, 4.22 level was safe.

Vols softer. After a downward plunge on volatility previous weeks, this week we had rather calm but only on the back fronted curve. Short tem volatilities were still offered - 1W is below 8.0%, the 1 month has moved down from 9.0% to 8.6%. 6 month is 9.8% mid. Risk reversals are also lower: 1 year 25D Risk reversal is now around 3.85%, 3m 25d RR is now 2.65%.

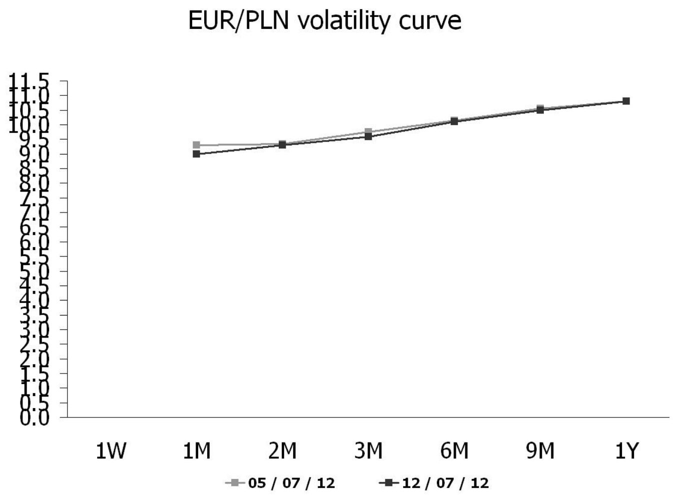


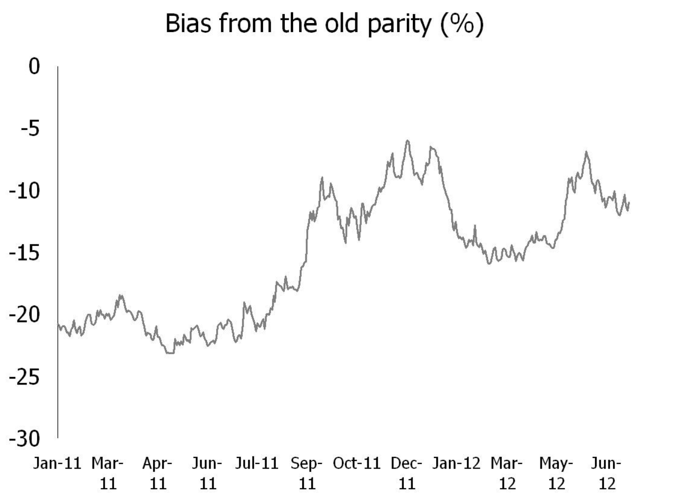
Short-term forecasts.

Main supports and resisances
EUR/PLN: 4.1200 / 4.2500
USD/PLN: 3.3250 / 3.5400

Spot. The zloty is back in vogue, and it is supported by bond inflows and the MoF's presence above 4.20. Unless the external environment sours, we could see 4.16 (key support) tested, then 4.12 is the next natural target. We remain, however, cautious on grounds of the external risks, and today's data releases. We would stay sidelined at the moment.

Derivatives. Vols have come off significantly over the past 4 weeks. We have experienced a very healthy supply of Vega. Realized volatilities are significantly higher then implied volatilities on all tenors except for 6m (for example 1m 10.5% realized versus 8.8% implied, 1y 11.4% realized versus 10.6 implied), so buying outright vanillas as gamma looks to be performing.





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
7/6/2012	4.73	5.13	4.85	5.06	5.13	5.06	5.12	5.09	4.87	4.66	4.47	4.86
7/9/2012	4.85	5.13	4.90	5.06	4.90	5.06	5.12	5.07	4.86	4.64	4.40	4.86
7/10/2012	4.73	5.13	5.00	5.06	4.98	5.06	5.10	5.09	4.83	4.62	4.39	4.83
7/11/2012	4.97	5.14	4.99	5.07	5.13	5.07	5.11	5.06	4.83	4.63	4.33	4.84
7/12/2012	4.90	5.13	5.19	5.06	5.19	5.06	5.12	5.03	4.75	4.54	4.32	4.75

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
52W TB	5/30/2011	5/30/2012	95.57	4.58	600	2667	505
OK0114	8/10/2011	1/25/2013	89.58	4.58	5000	4934	1889
PS1016	10/19/2011	10/25/2016	98.44	5.11	3600	11200	3638
DS1021	7/21/2011	10/25/2021	99.53	5.80	3000	5608	3000

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0113	5Y IRS	PS0416	10Y IRS	DS1019
7/6/2012	5.060	4.813	4.738	4.631	4.600	4.762	4.700	5.151
7/9/2012	5.060	4.813	4.697	4.596	4.579	4.746	4.650	5.138
7/10/2012	5.060	4.813	4.690	4.611	4.560	4.731	4.630	5.149
7/11/2012	5.070	4.813	4.718	4.649	4.570	4.738	4.640	5.111
7/12/2012	5.060	4.813	4.645	4.616	4.490	4.655	4.550	5.018

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
7/6/2012	9.10	9.75	10.15	10.80	10.80	4.00	0.83
7/9/2012	9.33	9.83	10.18	10.80	10.80	4.00	0.83
7/10/2012	9.13	9.68	10.08	10.75	10.75	4.00	0.83
7/11/2012	8.80	9.50	9.90	10.60	10.60	4.14	1.08
7/12/2012	9.00	9.60	10.10	10.80	10.80	4.16	1.09

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/6/2012	4.2178	3.4057	3.5119	4.2645	1.4717	0.1647
7/9/2012	4.2401	3.4538	3.5305	4.3373	1.4658	0.1653
7/10/2012	4.2041	3.4145	3.5004	4.3062	1.4637	0.1653
7/11/2012	4.1801	3.4007	3.4807	4.2906	1.4531	0.1648
7/12/2012	4.2008	3.4383	3.4979	4.3356	1.4527	0.1654

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