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Comment on the upcoming data and forecasts

This week the market awaits the data on GDP growth. The direction in GDP growth is certainly down, but we differ a bit from the market in terms of magnitude. We expect private consumption to decelerate further to 1.5% from 2.1% recorded in the previous month (consensus 1.9%). We also await slower growth of investment (at 4.7% vs consensus at 5.5% and last reading at 6.7%). Both elements of domestic demand find confirmation in VAT revenues (the fall on annual basis was particularly severe in July when the bulk of EURO2012 plays took place). The slowdown seems relatively properly priced in. This week also the data on inflation expectations are published. We expect a minor rebound (expectations are lagging behind current inflation usually by 1 month); the informative power of this survey measure has diminished recently as the NBP started to fiddle with the survey dates, breaking the usual relation with actual inflation and thereby hampering the process of drawing conclusions on the changes in subjective beliefs of consumers.

Polish data to watch: August 27th to August 31th

Publication	Date	Period	BRE	Consensus	Prior
GDP y/y (%)	30.08.	Q2	2.7	2.9	3.5
Inflation expectations y/y (%)	31.08.	Aug	3.7		3.5

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	18/25-10-12	5000	4.361	7/19/2012
5Y T-bond PS0417	12/19-09-12	4000	4.361	8/1/2012
10Y T-bond DS1021	12/19-09-12	4000	5.349	5/10/2012
20Y T-bond WS0429	12/19-09-12	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	4.3	3.50

	2011 Q3	2011 Q4	2012 Q1	2012 Q2 F	2012 Q3 F	2012 Q4 F
GDP y/y (%)	4.2	4.3	3.5	2.7	2.2	1.4
CPI Inflation y/y (average %)	4.1	4.6	3.9	4.0	3.9	3.2
Repo rate (end of period %)	4.50	4.50	4.50	4.75	4.75	4.25

F - forecast

Economics

50bp cut motion submitted and rejected. MPC holds fire so far to stay credible.

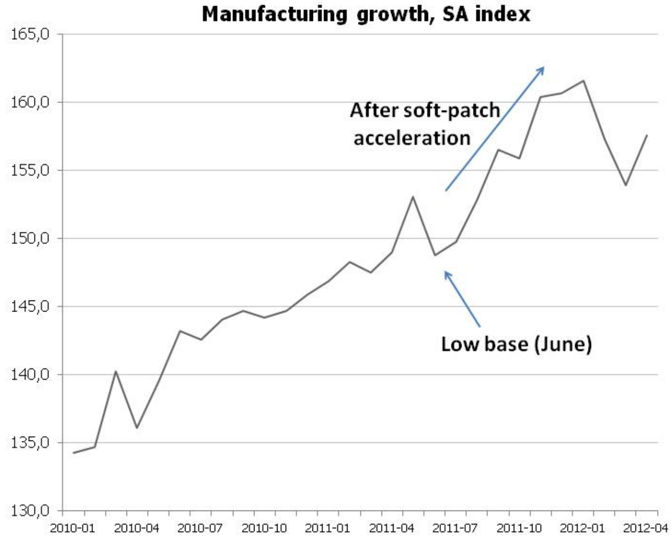
Discussion on the July MPC meeting was dominated by deepening internal and external slowdown. Inflation issue remained in the background as MPC majority accepts decelerating path of NBP inflation projection in the medium term. However, MPC is still familiar with the short term risks connected with base effects on food and fuels prices, increases in regulated prices and pro-inflationary effects of zloty appreciation.

While assessing the economic situation in Poland some Council members pointed out the negative influence of external factors as well as worse current economic data (industrial production, economic indicators and expectations). Although MPC referred also to more pessimistic scenarios, only "few" Council members believe in the economic growth coming markedly below the levels assumed in the NBP projection (lets add that forecasts from NBP projection are currently in the lower range of market expectations). Probably these were the two MPC members who put the motion to lower NBP interest rates (even by 50 bp) at the July's meeting. The motion did not pass as the majority assessed the current level of the rates as appropriate. The justification behind this assessment contains not only efforts to sustain macroeconomic stability but also reputational issues (urgent cut would put even more shadow on the decision of May's hike). This together with some better readings from July (see the piece below) will translate into keeping the rates unchanged also in September. We expect November inflation projection to be the most convenient moment to introduce a rate cut. In the whole cycle we expect loosening by more than 100bp till mid-2013 due to the both internal and external features of present slowdown (eventual symptoms of upturn in global economy won't be enough to balance lack of infrastructural projects and fiscal tightening), forthcoming cuts of ECB interest rates, stronger impact of credit channel (lack of new flow of foreign currency loans) and finally inflation falling to the NBP's target in the Autumn (1.5-3.5%).

Temporary better data in July

As we wrote above, recent bout of better real sphere data is set to constitute a good excuse for the MPC to hold fire until the fresh inflation projection is published (November). Here is our justification for the one-off nature of the readings.

Industrial output accelerated in July to 5.2% y/y after it hit 1.2% in June. In seasonally adjusted terms output grew by 4.7% after 2.9% in June. We think the acceleration is temporary and may be linked to a (also temporary?) revival in PMI indices which - at current circumstances - have probably more to do with the stock cycle than a fundamental improvement in the economy. Global trends are still negative (no significant improvement in the euro zone), zloty is stronger (therefore the „currency shield" is deactivated so far) which does not bode well for future readings. Along with mounting base effects (see the graph below), next months are likely to bring industrial output below zero, including the forthcoming August reading.



Construction output decreased by 8.8% y/y in July. The most severe drops were recorded in infrastructure investment (-12.9% y/y); other categories dived in much slower pace. It is worth to note that the fall occurred during favorable weather conditions. This confirms that public investment is set to generate negative contribution to GDP growth from Q3 onwards. We forecast negative investment growth (overall: public + private) at the beginning of 2013. Taking into consideration the dynamics of the dying out effect in infrastructure we cannot exclude that negative growth rates will come earlier and be deeper.

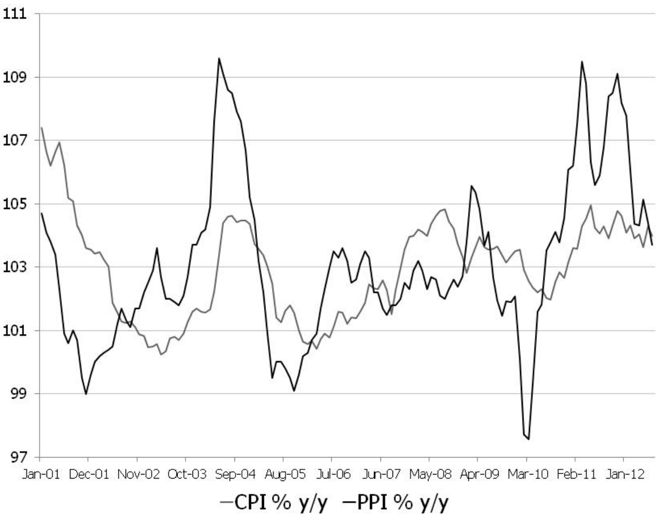
Retail sales recorded a slight rebound in July from 6.4% y/y to 6.9%. We think that this is only corrective and the trend (whether it is consumption or retail sales) is still downward sloping. Firstly, the scale of acceleration is minor and can be easily linked to working days effect (statistically one working day more on annual basis generates a boost to annual growth rate of sales ranging from 0.5 to 1pp.). Secondly, the composition of acceleration hinges mainly on the most volatile categories in which the acceleration can be easily linked to base effect from the previous year. Thirdly, in current circumstances the rebound is not economically viable. As this is the most important channel now we elaborate more on this below.

In our opinion, the deceleration of consumption has been mostly related to higher inflation (real wages growth channel) and worse expected household financial situation. Both measures have still some room to turn more negative in the coming months. Moreover, it has been widely proved that it is employment that is the most significant macroeconomic variable affecting consumption growth in emerging markets. It is because employment perspectives have strong explanatory power in determining the future path of household income (job loss in more irreversible and more acute in terms of income than simple wage freeze or wage reduction). We think that current, relatively stable path of employment so far (only minor decreases in workforce, strictly more benign than the ones recorded in 2009-2010) is going to change for worse in the coming months because a sharp dip in firm's financial results (-33% y/y in Q2 2012) ought to launch cost-cutting efforts. As we believe there is not much progress to be made in organizational efficiency of enterprises (they mostly restructured in 2009), there is only room for conventional cost-cutting measures basing on reduction of wages and employment. Normally, flexible prices and wages would change in order to restore equilibrium of the economy. Prices and wages are sticky, though, therefore the process will not be swift; employment cuts seem to be easier (the more so since enterprises possibly make already use of flexible working hours). There is also a distinctive feature of the current slowdown. It stems from a deficiencies of domestic demand. Therefore it affects the higher percentage of enterprises and - more importantly - return to equilibrium cannot be accelerated by swift corrective measure, namely the exchange rate. This predicament of the economy (no obvious growth driver, impaired nominal adjustment channels) suggests that the direction of the Polish economy is still down and that now it is the time when the deceleration is set to gain momentum.

Technically, CPI is poised to come down in coming months

Recent reading of producer prices delivered a long awaited ”technical” signal for falling inflation. We first take a quick look at the evolution of producer prices and then return to this issue.

Producer prices increased in July by 3.7% y/y vs 4.4% in the previous month. Manufacturers quote lower and lower prices on monthly basis. This stems partially from stronger zloty which allows for lower prices for importers, and partially from competitive pressure arising on a shrinking market. Cyclical easing of price pressure is set to intensify along with the more pronounced slowdown in the real sphere. Assuming neutral scenario for commodity prices this may bring annual producer price inflation down to close to zero before year’s end.



July was the first month for 3 years in which producer prices growth became lower than the growth recorded in their consumer counterpart (CPI) - see the graph. This ”technical” reasoning allows for conclusion than the necessary condition for falling CPI has been already met. Indeed we also expect consumer prices to fall owing to more fundamental reasons. We will keep you updated whether this ”technical” signal proves long-lasting.

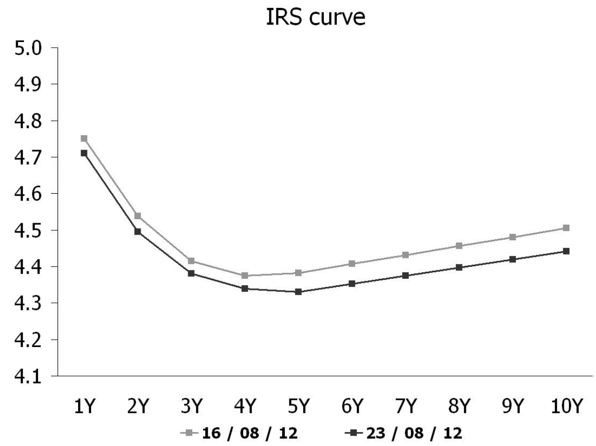
Fixed income

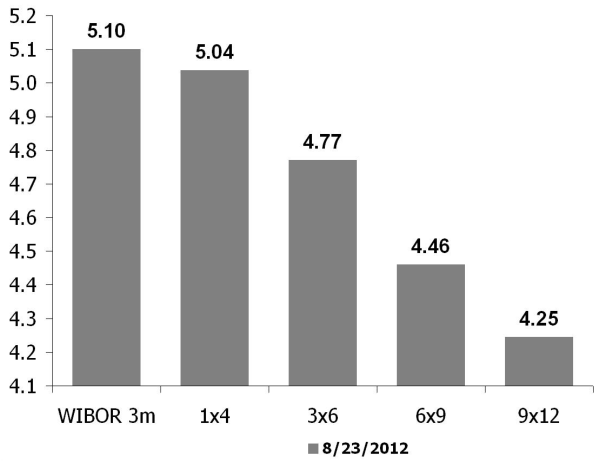
Hints from history

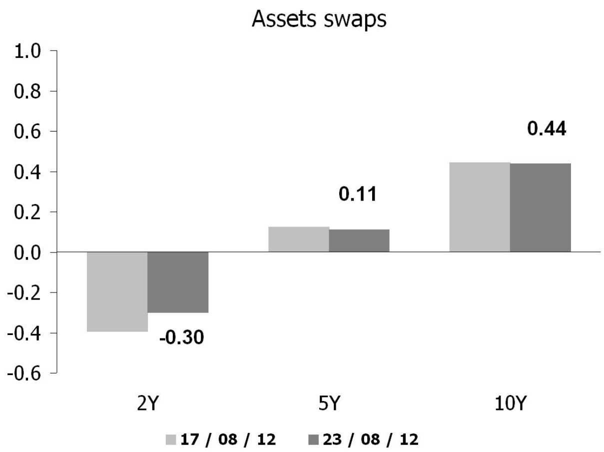
Last week was rather calm on FI market. Rates changed very little and bonds remained in rather tight range. Local volatility was caused by mixture of economic releases and sentiment on core markets. Generally market seems to be in a holiday mood. Next week we will have GDP data for 2Q which will be quite important, and most likely they will show that economic slowdown has already begun. We will also have issuance calendar for September. We think MinFin will issue more bonds compared to August, but that should have rather limited impact on bond prices.

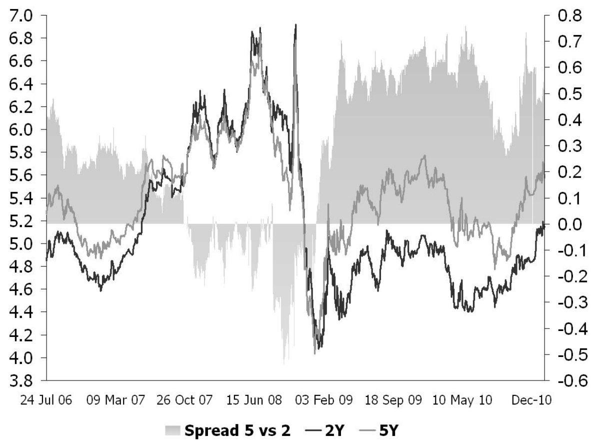
As for our view, we are still in the bulls camp, we think the curve has potential to bull steepen from current levels. We also think that current scenario of 75-100 bp cut that should realize in 3-12 months horizon is least what will happen. The rationale for such scenario is the fact that current slowdown is much different compared to previous one. There is hardly any chance for fiscal stimulus, EURPLN lvl is not as beneficial as it was for exporters in 2008/2009, and consumers are already spending from their savings (according to the least NBP survey first time since 2000). RPP may be still cautious with their assessment of the economy and spot CPI can be treated as the reason to hold rates form 2-3 months.

Also history would suggest that current RPP is more on the hawkish side, but it is worth remembering one thing. As they are rather backward looking they are also very reactive to the spot economic releases. And they can start to be a real shocker once IP starts to print negative, retail sales will also print negative in real terms, CPI especially core CPI will be down-trending and GDP dynamics will start to print heavily below potential. We made an exercise and applied Taylor rule to NBP CPI and Growth projection (released in June) and it suggests rates at around 3.0/3.25 level. What you think next CPI and GDP projection will be? Higher?





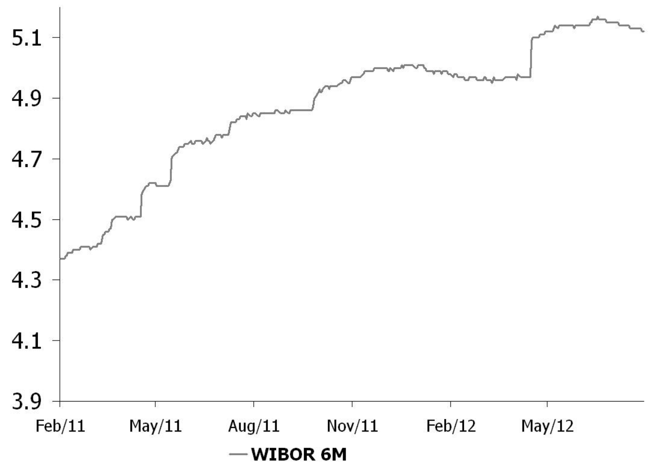




Money market

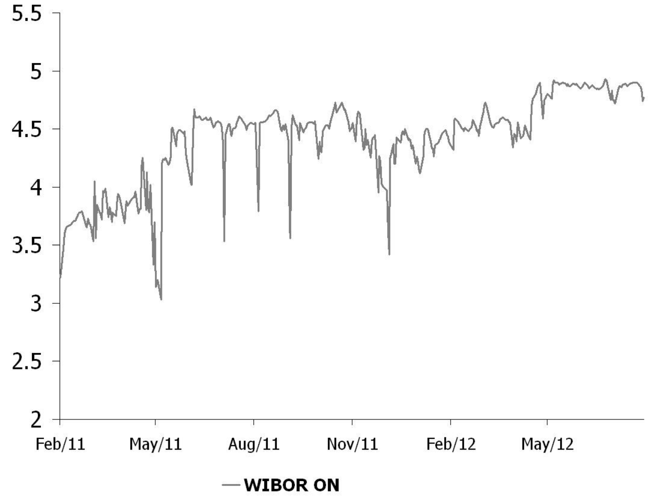
Stable cost of carry.

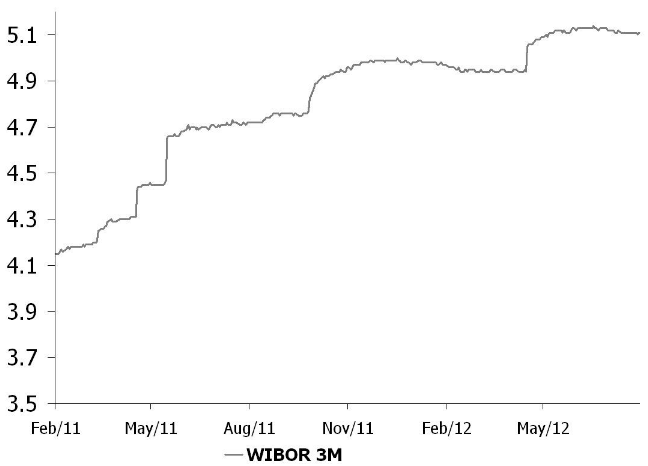
End of the reserve may be expensive. A bit softer on the liquidity side, since the central bank did not come up with additional operations, leaving some space for market activity. Next week we have end of the reserve settlement period and market is left square after regular OMO, during which 106 billion pln of money bills were sold. In local reality square is more like short, therefore short rates should go up in coming days.

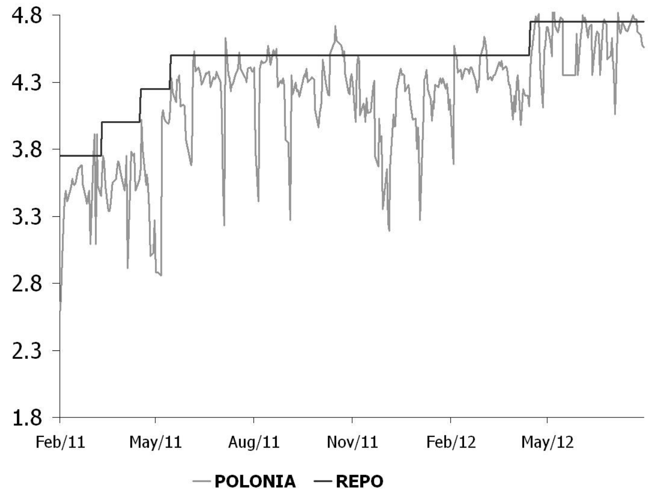


November most likely for the first cut. Good industrial output and retail sales figures should postpone the eagerness for the monetary policy easing during the September meeting. November looks most likely as of now, however coming data may change the game for October.

July minutes showed motions to cut (50 and 25 bps) being voted, however they were supported only by the biggest doves, still leaving the support too negligible to surprise the market in September.



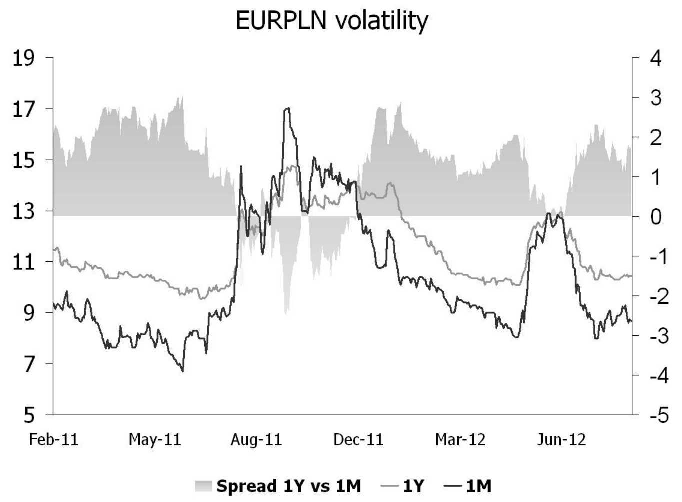




Forex

Correction in the trend or...? Buy the rumor sell the fact! The announcement of the next round of QE (fairly soon) had only a short term effect on PLN. After not being able to crack the 4.04/4.05 support zone, the EUR/PLN tried north and this time has decisively broken 4.10 resistance zone (4.1150 high so far). The MPC minutes showed growing chances for the rate cut and the rumors of dividend outflows also weighted towards negative sentiment.

Bid in Vol The volatility curve in EUR/PLN is higher by just a tic! 1month mid ATM is today 8.5% versus last week 8.4%, 1 year is now 10.5% versus 10.4%. But it will not illustrate well the price action. After the weeks or month of selling the market finally caught some bids, the 2 month was PAID at 8.85 (bid on) the 1 year was also PAID at 10.5%... Thrilling...

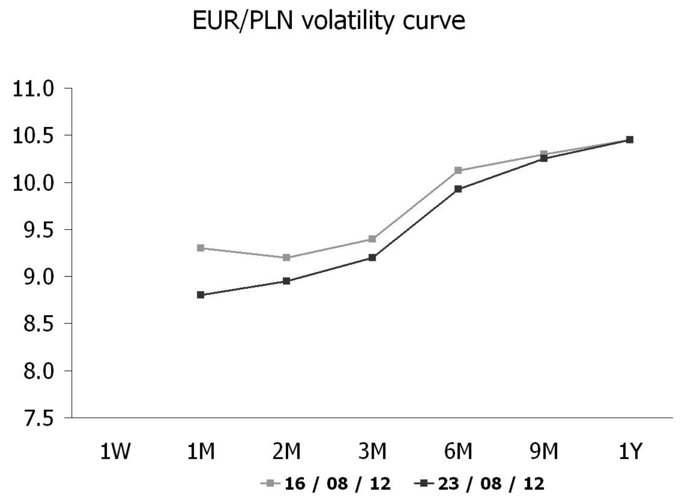


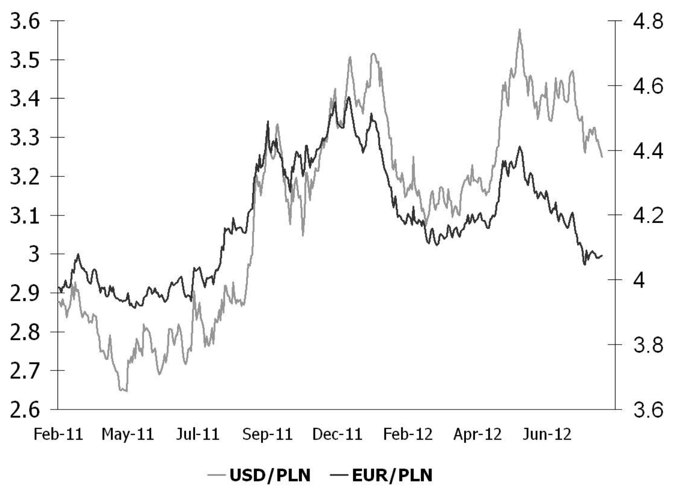
Short-term forecasts.

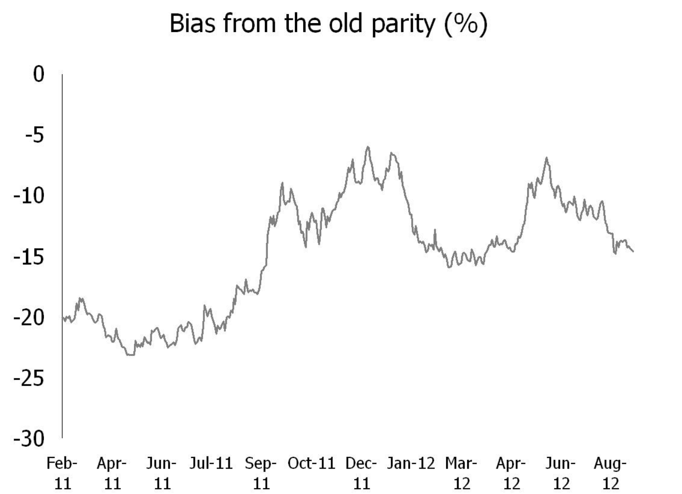
Main supports and resisances
EUR/PLN: 4.0250 / 4.1400
USD/PLN: 3.2000 / 3.4000

Spot. The risks that ECB and Fed will not deliver what is already being taken for granted by the markets are substantial. And that alone may provoke a deeper correction on all emerging markets (PLN included). We would like to buy EUR/PLN at 4.0800. With a stop below 4.05 and target 4.14.

Derivatives. Beside the spike in spot, realized volatility in EUR/PLN is still extremely low , that is preventing us from adding to already long in backend Vega. But we are eager to add to our long, if realized vol would show same justification for that.







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
8/16/2012	4.75	5.11	4.79	6.49	4.79	6.59	5.05	4.82	4.53	4.32	4.13	4.56
8/17/2012	4.90	5.11	5.01	5.03	4.96	5.03	5.05	4.79	4.54	4.31	4.15	4.57
8/20/2012	4.81	5.11	4.82	5.03	4.84	5.03	5.05	4.82	4.52	4.29	4.14	4.55
8/21/2012	4.85	5.10	4.99	5.02	4.95	5.02	5.05	4.82	4.51	4.31	4.17	4.55
8/23/2012	4.94	5.11	5.04	5.02	4.95	5.02	5.04	4.77	4.46	4.25	4.12	4.49

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
8/16/2012	6.590	4.813	4.538	4.154	4.383	4.515	4.505	4.962
8/17/2012	5.030	4.813	4.530	4.137	4.378	4.503	4.495	4.939
8/20/2012	5.030	4.813	4.530	4.172	4.366	4.474	4.491	4.932
8/21/2012	5.020	4.813	4.533	4.140	4.362	4.471	4.483	4.912
8/23/2012	5.020	4.813	4.495	4.197	4.330	4.442	4.442	4.882

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
8/16/2012	9.30	9.40	10.13	10.45	10.45	3.58	0.78
8/17/2012	8.80	9.30	9.98	10.50	10.50	3.58	0.78
8/20/2012	8.60	9.20	9.80	10.40	10.40	4.01	1.11
8/21/2012	8.75	9.25	9.83	10.45	10.45	3.57	0.78
8/23/2012	8.80	9.20	9.93	10.45	10.45	3.56	0.78

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/16/2012	4.0820	3.3253	3.3998	4.2007	1.4668	0.1639
8/17/2012	4.0680	3.2886	3.3868	4.1402	1.4623	0.1636
8/20/2012	4.0684	3.2944	3.3871	4.1432	1.4669	0.1633
8/21/2012	4.0683	3.2790	3.3874	4.1290	1.4735	0.1639
8/23/2012	4.0756	3.2488	3.3939	4.1358	1.4751	0.1636

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