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Comment on the upcoming data and forecasts

After last two weeks' barrage of data, only two figures will be published next week. On Wednesday, latest Manufacturing PMI will be released. After last week's negative surprises in Germany and the Eurozone, as well as the grim outlook for Poland visible in latest macroeconomic figures, further deterioration in headline will hardly be surprising. On Wednesday, the NBP will also publish inflation expectations for October. The release is set to point out to a further deceleration of inflation perceptions of households.

Polish data to watch: October 22nd to October 26th

Publication	Date	Period	BRE	Consensus	Prior
PMI	31.10.	Oct			47.0
Inflation expectations	31.10.	Oct	3.8	4.0	4.1

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	-	-	4.361	10/23/2012
5Y T-bond PS0417	11/8/2012	1000	4.361	10/4/2012
10Y T-bond DS1021	-	-	4.944	10/23/2012
20Y T-bond WS0429	11/8/2012	4000	5.563	5/10/2012

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



Comment

Surprise index in downtrend - analysts' still too optimistic about Polish economy.

* 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

- Consensus view on the Polish economy is too optimistic. Polish economy is set to enter recession in H1 2013 (negative GDP growth in y/y terms) and substantial acceleration afterwards is so far unlikely.
- External developments in H1 2013 (euro zone fails to accelerate soon) at most neutral for Polish exports (and GDP).
- Polish government committed to the convergence path, though in an unorthodox way. Very limited room for fiscal stimulation due to limited financial markets tolerance for higher debt. GG deficit no higher than 4% (minor impact for the economy, support for Polish bonds).
- Weaker domestic demand is the main cause of recession. Consumption stagnates due to extremely low savings rate (the value of assets also fell recently) and negative real income growth. Infrastructure gap puts public investment growth into (substantial) negative rates; private investment suffers from weak outlook (tipping point in corporate lending).
- Inflation set to moderate in the near term on statistical effects (high base from 2012) and in mid-term on lower core inflation (close to 1% in mid 2013). CPI returns to target in Q1/Q2 2013.
- MPC to apply proper easing cycle starting from November. Realization of our scenario set to force MPC to cut more than they previously think is necessary. We bet on 150bps easing.

Financial markets

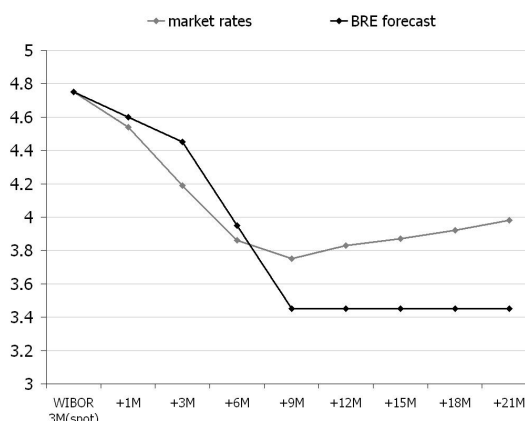
- Zloty moderately weaker towards the end of the year. Despite weaker economy and lower rates usual cyclical pattern for EURPLN set to be distorted by more balanced fiscal policy and accompanying lower current account deficit.
- Room for lower yields in short term bonds (monetary easing, carry trades). Correction setup on long-term bonds (but still waiting for a trigger: can be extreme global risk-on or risk-off). Yield curve to steepen eventually. In general, low yield environment set to continue in 2013 (no dramatic rise in yields; 4,2-4.9 range for 10Y bond).
- Volatility lower due to so-called ECB put.

BRE forecasts

	2008	2009	2010	2011	2012 F	2013 F
GDP y/y (%)	5.1	1.6	3.9	4.3	2.1	0-0.5
CPI Inflation y/y (average %)	4.3	3.5	2.8	4.2	3.8	2.5
Current account (%GDP)	-5.3	-1.6	-4.5	-4.9	-2.6	-2.0
Unemployment rate (end of period %)	9.5	12.1	12.4	12.5	13.0	14.2
Repo rate (end of period %)	5.00	3.50	3.50	4.50	4.25	3.25

	2012 Q1	2012 Q2	2012 Q3 F	2012 Q4 F	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.6	2.3	1.6	1.0	-0.6	-0.4	0.4	1.4
Individual consumption y/y (%)	1.7	1.2	0.8	0.7	0.5	0.3	0.6	1.1
Public Consumption y/y (%)	-0.8	0.5	1.2	1.2	0.5	0.5	0.5	0.5
Investment y/y (%)	6.0	1.3	-3.0	-6.0	-7.0	-6.0	-5.0	-3.0
Inflation rate (% average)	3.9	4.0	3.9	3.2	2.6	2.4	2.3	2.5
Unemployment rate (% eop)	13.3	12.4	12.4	13.0	13.2	13.3	13.5	14.2
NBP repo rate (% eop)	4.50	4.75	4.75	4.25	3.75	3.25	3.25	3.25
Wibor 3M (% eop)	4.94	5.13	4.92	4.45	3.95	3.45	3.45	3.45
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.73	3.62	3.55	3.75	3.80
10Y Polish bond yields (% eop)	5.50	5.15	4.69	4.55	4.40	4.50	4.65	4.65
EUR/PLN (eop)	4.15	4.22	4.12	4.25	4.30	4.20	4.10	4.00
USD/PLN (eop)	3.11	3.35	3.20	3.32	3.23	3.11	3.15	3.20

F - forecast



Economics

Real sales: Clear downtrend on retail sales

In September retail sales grew by 3.1% y/y (in nominal terms) after 5.8% recorded in the previous month. The summary is short - the downtrend observed in sales data continues. The slowdown is broad-based. Deeper drop was partially induced by the negative difference in working days in September (especially in food and wide „other“ category). Moreover, the weakness in auto sales is strengthening (in September it decreased by 7.6% after -2% in August), which fits into recent global trend on this market.

Retail sales y/y in current and constant prices



In real terms retail sales dropped by 0.4% y/y (which is the first negative number in 28 months). Record low savings rate and pressure on its reconstruction in more and more pessimistic economic environment makes current income the main determinant of private consumption. With deteriorating labor market conditions (monthly drops of employment, substantially lower wage growth) current income in real terms decreases systematically. Therefore, further deceleration in retail sales and consumption dynamics in the coming months is almost certain. This, together with weak investment activity and lower exports dynamics makes negative annual GDP growth not so unimaginable. We expect economic growth to hit 0% in Q1 or Q2'2013.

The data had only limited impact on the debt market (rates decreased only slightly), but resulted in PLN weakening by about 0.5%. Together with all other weak September data the release of retail sales figures supports expected interest rate cut on November MPC meeting, which seems to be a done deal now. We also expect MPC to adjust its relatively optimistic diagnosis of Polish economy and deliver a more dovish statement.

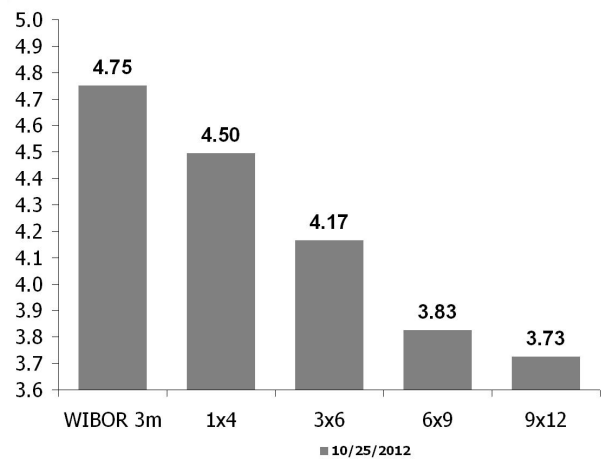
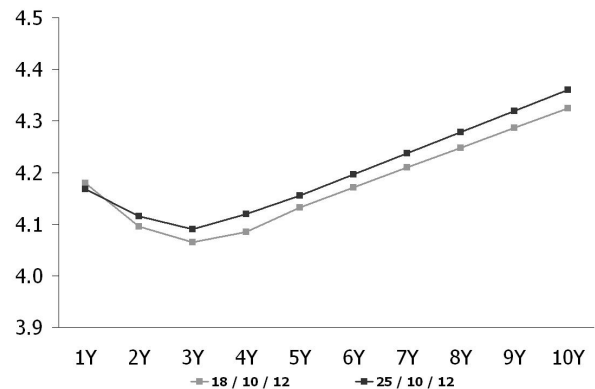


Fixed income

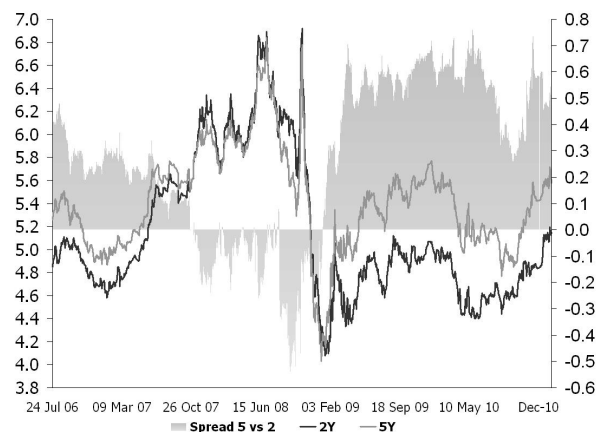
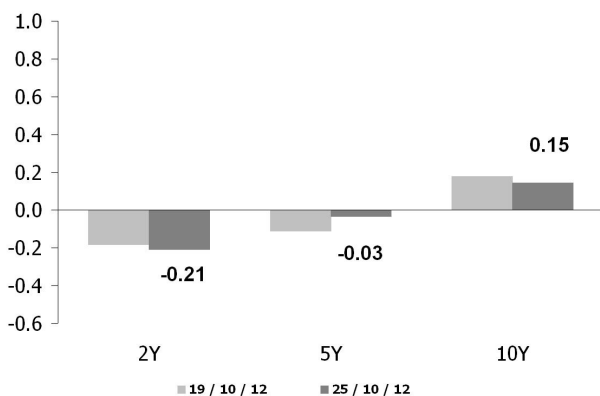
Further steepening ahead

Positive sentiment continued on the market in the first half of the week. Bonds and rates rallied again, with bond yields hitting all-time lows on 2 and 5y and fresh records in 10y sector. Retail sales data published on Tuesday came lower than expected and therefore supported the market. Also latest comments from MPC members were mainly in dovish tone. The Finance Ministry sold close to 8 bio of bonds in the auction, including over 5 bio of new 10 year benchmark, DS1023 at yield slightly below 4.50%. Such supply at least temporarily satisfied market's appetite for risk and some correction started. Yields rebounded by some 5-7bp and curve steepened a bit. As a 25bp rate cut next month is almost certain, front end of the curve should remain well-supported, however we expect further pressure in the long end. Naturally, we do not exclude another attempts to break previous highs in bond prices, we would consider that a selling opportunity, though.

IRS curve



Assets swaps

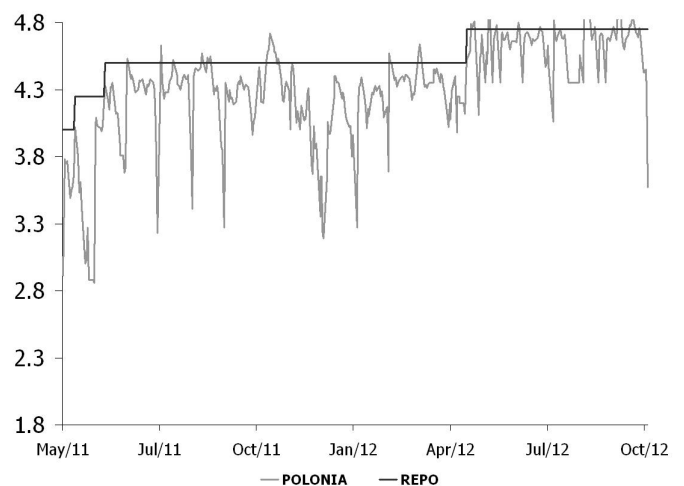
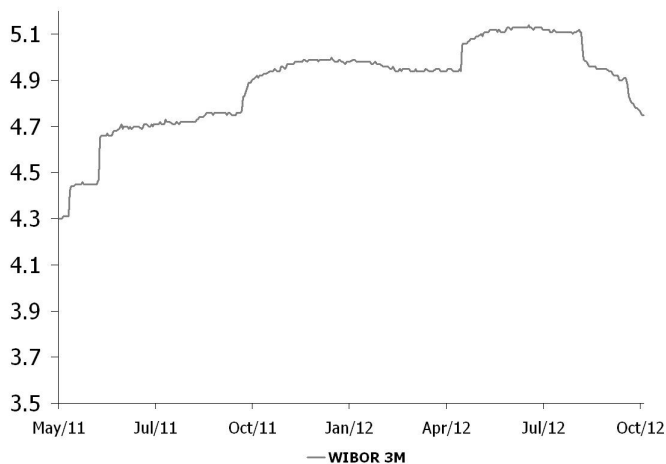
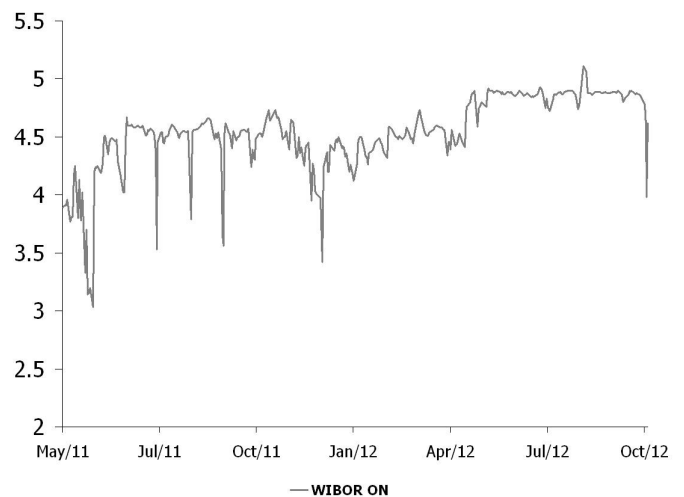
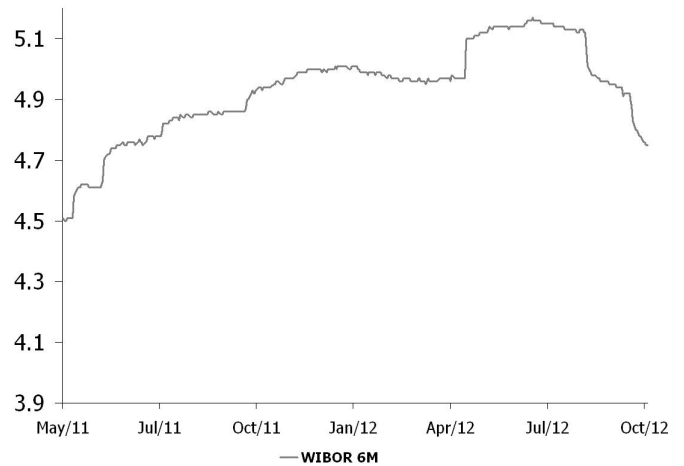




Money market

2 money bills auctions today. Cash should be much higher next week (this week it dropped below 4%) thanks to the surprising move of the Central Bank. Besides regular open market operations the central bank decided to do another auction for 4-day bills (end of the reserve is on Tuesday). This additional auction is without precedent (previously, 2 auctions in one day were only held if the last day of the reserve was on Friday). This new strategy shows clearly that determination to keep cash rates close to the main market rate grows and is not going to cease soon. It should be taken into consideration while pricing OIS contracts.

Modestly aggressive scenario for rates. Bullish sentiment goes quite well, despite being a bit softer after a relatively poor bond auction. Retail sales figures confirmed the inevitability of the slowdown in the economy and supported rate cuts expectations. In our opinion November 25 bps cut is certain, but the timing and scale of consecutive cuts remain in question. Market prices cuts amounting to a total of 125 bps in 6 months. OIS curve anticipates those cuts coming every month now. We perceive this scenario to be a bit too aggressive.





Forex

Slightly weaker PLN. The global investment climate is a little sour this week. Weaker stocks, lower EUR/USD and higher yields in peripheral Europe translated into weaker Złoty (4.1650 EUR/PLN high so far). We are now close to the upper band of the current range (4.05-4.15). Interest rate cut in November seems to be almost certain, given the weaker macro data delivered this week. The price action in polish Bonds market will be crucial for PLN. We are at all time highs, but hunger for yields seems to be unstoppable.

Consolidation. The correlation between weaker PLN and higher volatility is still in place, but this time only the front end reacted. The short-term options were in demand, and as a result the 1M mid EUR/PLN is 7.5%, roughly 0.5% higher than last week. The body / back end of the curve is unimpressed by PLN losses so far and EUR/PLN 6m ATM is still 8.8% and 1 year 9.6%. The risk reversals are thus higher only in the front end, and currency spread (deferece between USD/PLN vol and EUR/PLN vol) is better bid by 0.25%.

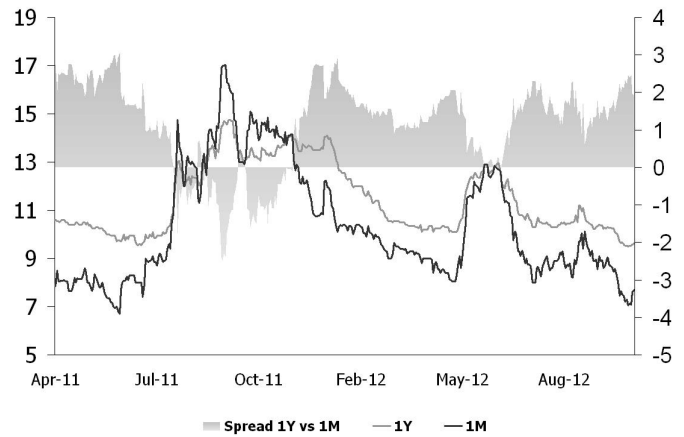
Short-term forecasts.

Main supports and resisances
 EUR/PLN: 4.0500 / 4.1800
 USD/PLN: 3.1000 / 3.2700

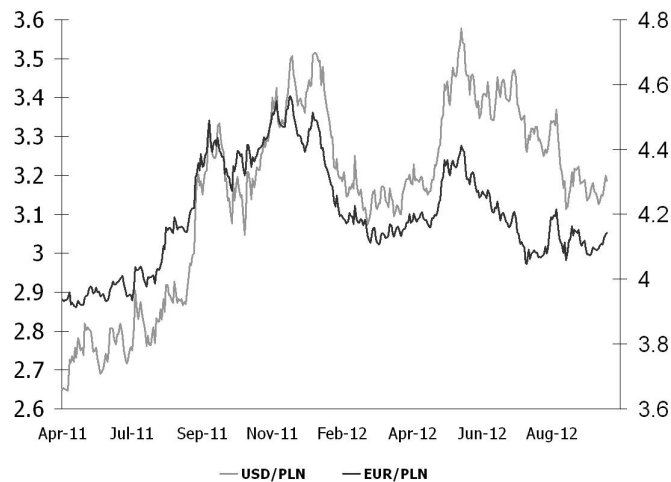
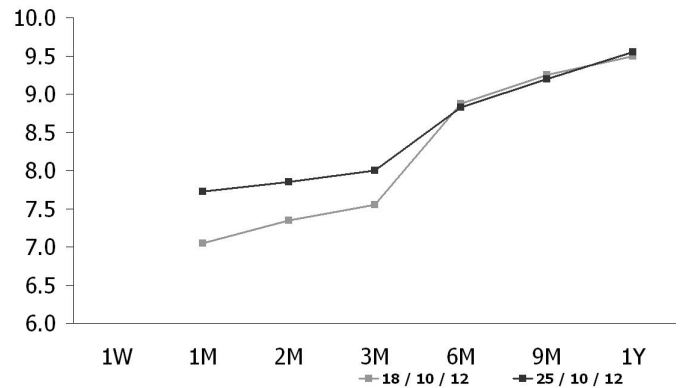
Spot. Playing the range is still the name of the game in this environment. But that range is a little bit wider to the right, namely 4.1800/4.2000 constitutes the higher band. The shorts from 4.13 stopped. We are looking to sell 4.1750/4.1850 with a stop above 4.20 and hopes for 4.10. We are mimicking EUR/USD/global factors until the MPC meeting on 7th of November. That is when Polish factors may again play a dominant role.

Derivatives. The sell off in the middle and the back end is quite impressive. Implied volatilities are at the lowest levels since „Lehman time” but there are still no bids. The closer to the end of the year, the more protection from Minister of Finance PLN may have (last year EUR/PLN was sold by MF to ensure that debt to GDP ratio is under control). As a consequence, the chances for spikes in vols are less likely in the coming weeks...

EURPLN volatility



EUR/PLN volatility curve



Bias from the old parity (%)





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
10/19/2012	4.68	4.78	4.68	6.49	4.61	6.59	4.53	4.20	3.85	3.74	3.77	3.87
10/22/2012	4.65	4.77	4.63	4.66	4.53	4.66	4.51	4.20	3.85	3.73	3.74	3.85
10/23/2012	4.63	4.76	4.58	4.66	4.40	4.65	4.52	4.19	3.83	3.72	3.74	3.83
10/24/2012	4.53	4.75	4.50	4.65	4.43	4.65	4.50	4.19	3.83	3.73	3.74	3.82
10/25/2012	4.51	4.75	4.53	4.65	4.46	4.65	4.50	4.17	3.83	3.73	3.77	3.85

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
10/19/2012	6.590	4.813	4.098	3.914	4.113	4.003	4.300	4.479
10/22/2012	4.660	4.813	4.090	3.888	4.111	4.037	4.290	4.474
10/23/2012	4.650	4.813	4.090	3.910	4.120	4.068	4.310	4.479
10/24/2012	4.650	4.813	4.100	3.917	4.130	4.116	4.335	4.506
10/25/2012	4.650	4.813	4.115	3.907	4.155	4.122	4.360	4.505

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/19/2012	7.13	7.65	8.83	9.53	9.53	3.46	0.75
10/22/2012	7.08	7.65	8.88	9.53	9.53	3.46	0.75
10/23/2012	7.60	8.00	8.98	9.58	9.58	3.46	0.75
10/24/2012	7.70	8.15	8.88	9.63	9.63	3.47	0.76
10/25/2012	7.73	8.00	8.83	9.55	9.55	3.44	0.75

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/19/2012	4.1103	3.1499	3.3996	3.9700	1.4739	0.1655
10/22/2012	4.1056	3.1470	3.3921	3.9447	1.4709	0.1652
10/23/2012	4.1266	3.1662	3.4114	3.9700	1.4720	0.1656
10/24/2012	4.1374	3.1996	3.4206	4.0105	1.4720	0.1658
10/25/2012	4.1430	3.1851	3.4240	3.9720	1.4822	0.1661

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