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**Comment on the upcoming data and forecasts**

All eyes on the Monetary Policy Committee. On Wednesday, the MPC will announce its decision regarding interest rates. Different arguments point out to an interest rate cut this month: inflation pressure is receding (unexpectedly strong deceleration in headline and core inflation rates) and macroeconomic data released in October have been surprisingly weak (retail sales, industrial production, construction output, corporate wages and employment). We believe that the MPC will cut interest rates by 25 bps and release a dovish statement, thereby opening a new sequence of rate cuts.

**Polish data to watch: November 5th to November 9th**

Publication	Date	Period	BRE	Consensus	Prior
MPC rate decision (%)	7.11.	Nov	4.50	4.50	4.75

**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	-	5000	3.856	10/23/2012
5Y T-bond PS0417	11/8/2012	1000	4.220	10/4/2012
10Y T-bond DS1021	-	3000	4.496	10/23/2012
20Y T-bond WS0429	-	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.

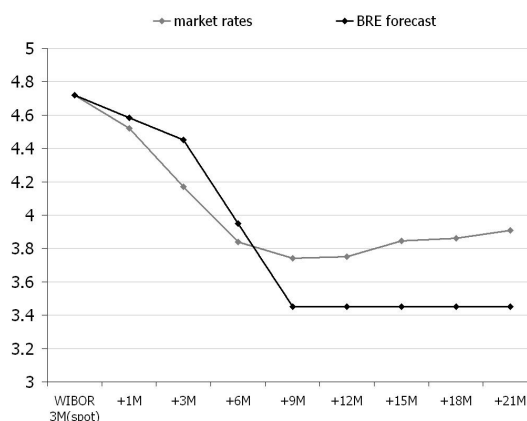
### BRE forecasts

	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



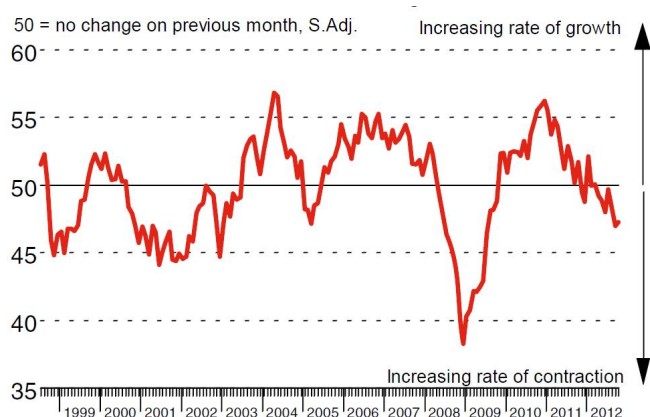


## Economics

### Polish industry slows down for seventh month in a row

Polish manufacturing PMI dropped below 50 points for seventh month in a row - in October it averaged at 47.3 pts. compared to 47.0 pts. in September. The unexpected rise in the headline index (market consensus placed its value at 46.6) points out to a slight deceleration in the rate of economic decline. However, we interpret it as a correction after last month's surprisingly deep slump, reinforced by a strong working day effect (+2 y/y in October, -2 y/y in September).

deepest decline in export orders in 40 months reported by Polish manufacturers clearly shows that external factors have a significant influence over economic activity in Poland. We expect that the increasingly more pronounced economic slowdown will be eventually met with the response from monetary policy - we expect MPC to start an interest rate cutting cycle in November (with 25bp. cut).



Detailed analysis of survey data indicates a considerable shortage of new orders - so far this has been the biggest factor in the observed decline of the headline index. Admittedly, in October this sub-index bounced back from its 39-month low noted in September. Moreover, export orders were significantly weaker and its decline rate surged. Decline in output growth was slightly smaller than last month but still forced companies to decrease employment in second month in a row and at a fastest rate since October 2009. Entrepreneurs also curtailed its purchases and inventories of final goods and raw materials. Weak demand for commodities and strenghtening of PLN contributed to a decrease in average production costs and prices of final goods (facilitated by strong competition as well).

We believe that further decline in Polish manufacturing PMI in the forthcoming months is still highly probable. Decline in new orders, employment and raw materials inventories observed in October inambiguously indicates that industrial production will weaken even further in the next months. This might translate into negative yearly growth rates of industrial production and employment, although working day effects (2 more days) will support the former in October. Our forecast, in line with the market consensus, points out to a 1.7% y/y increase of industrial production in October.

To sum up, any positive interpretation of the latest manufacturing PMI release is not justified - a breakdown of data clearly indicates that a rebound in headline PMI (i.e. return to a growth path) is essentially impossible in the next several months. This conclusion is supported by business tendency indicators published by the Central Statistical Office (with a firm downward trend) and by European business climate indices. Short-term correlation with the latter has somewhat waned recently but the

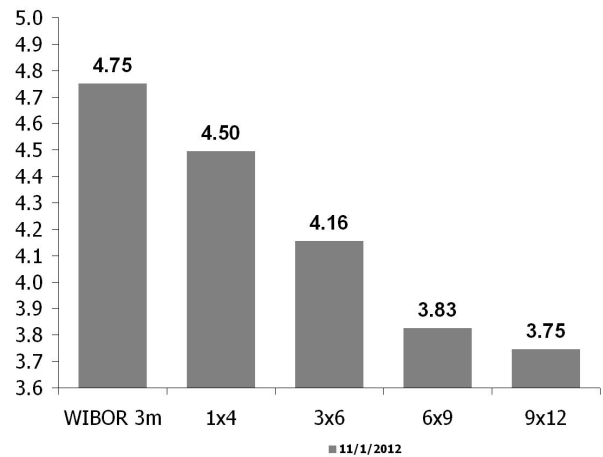
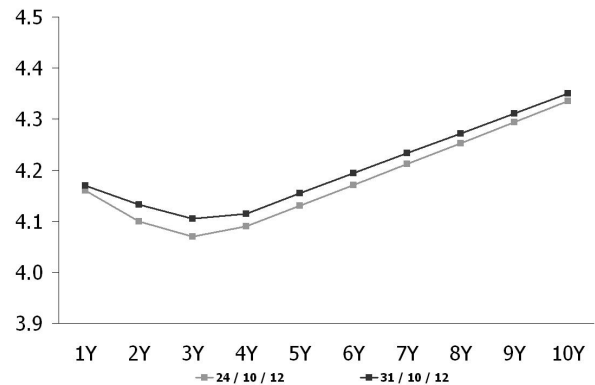


### Fixed income

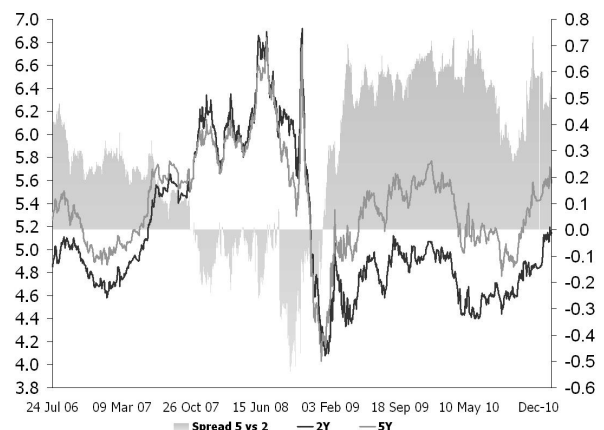
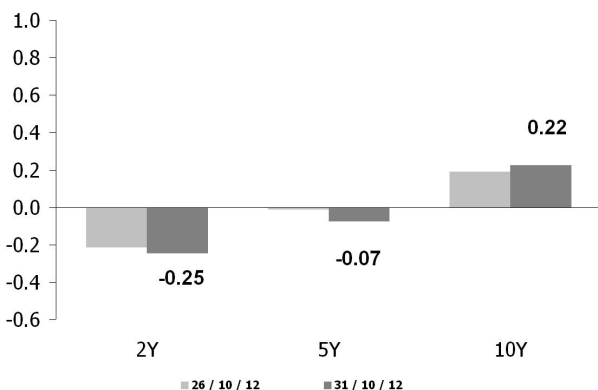
#### Awaiting MPC's decision

Last week was surprisingly volatile, especially considering that Thursday's holiday usually causes long weekend effects and therefore limited activity. Instead we observed some erratic movements on the market. It started with quite a sharp correction that hit mainly long end of the curve, followed by a strong rebound, which pushed 10y bond prices to fresh highs. Also yields in the very front end of the curve pushed significantly lower, which seems quite surprising, as a 125bp easing cycle had already been priced in before. We still think that this rally is getting a bit overdone and what could possibly push yields even lower is the MPC meeting next week, but only if rate setters turn to be extremely dovish or actually cut rates by more than 25bp. None of this is really likely to happen, so we think that payout from pay positions at current levels is quite assymmetric, as 25bp cut followed by only mildly dovish comment might be read as a bit of disappointment.

IRS curve



Assets swaps

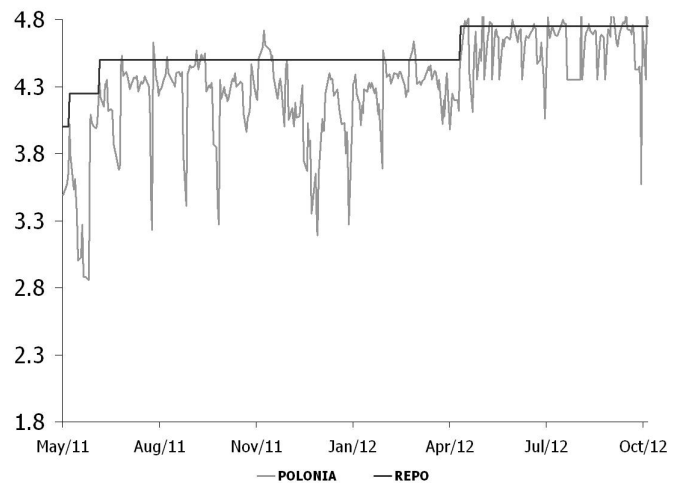
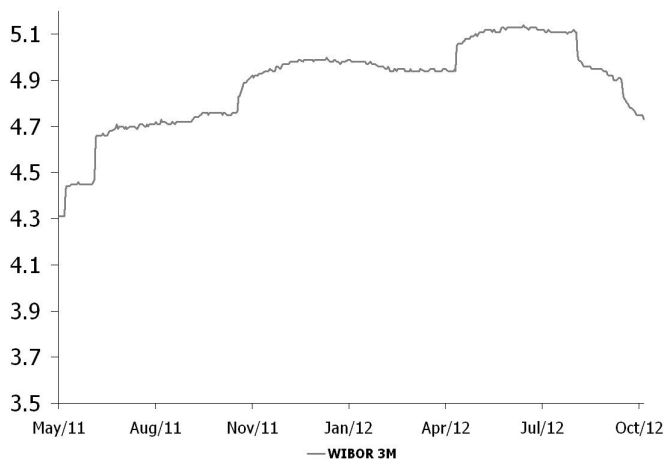
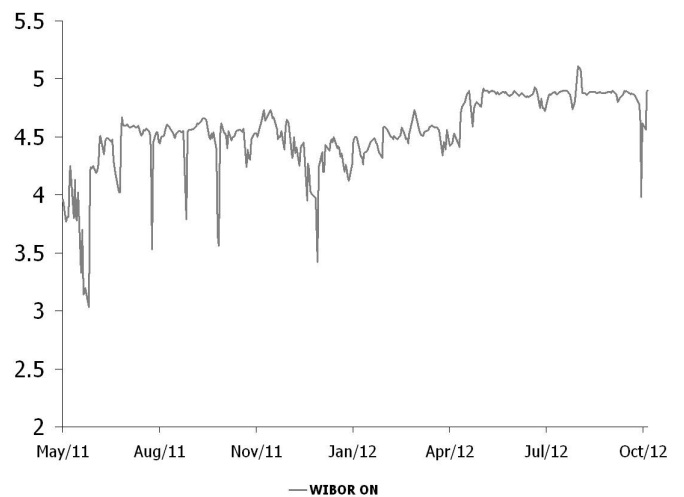
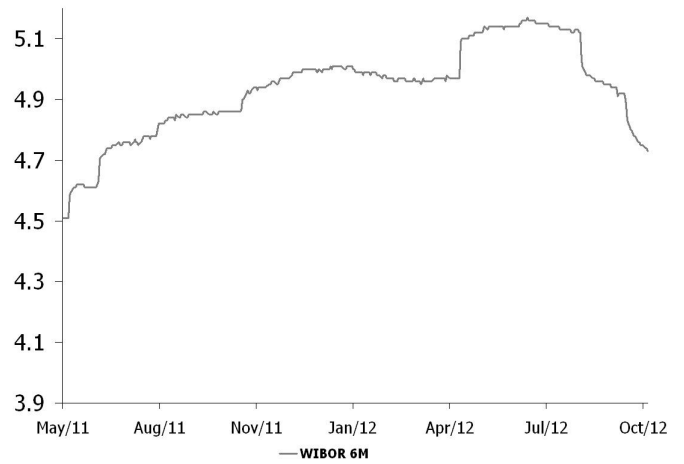




### Money market

**Squared liquidity** Quiet week due to holiday with restricted liquidity and flows. The NBP offered 105,5 bln pln of money bills out of which 105,5 was bought. It more or less means the short-est rates will stay around the main market rate.

**Market expects 25 bps rates cut next Wednesday**  
Market is waiting for the MPC meeting and expects 25 bps cut. This is also in line with our forecast.





### Forex

**Back in the range.** The 4,1650 resistance line in EUR/PLN was too tough to overcome. After two failed attempts, we have slipped back into well-known territory. 4,08/4,1650 is in play now, and lets say it loud, we are trading water. We doubt if Friday's NFP numbers will produce much excitement for PLN crosses - we have to wait until MPC meeting and rate decision on November 7th for things to become more interesting eventually.

**Lower again.** The realized volatility for EUR/PLN 1 week ATM slips bellow 6 (for high frequency model) - namely 5,74, which is really low. Consequently, after a small break the sell off in vols continues. This time the volatility curve shifts down in a parallel fashion, so that the biggest losses are attached to the backend. The 1 month EUR/PLN ATM now is 6.9% mid versus 7.5% last week. In the backend of the curve the 6 months EUR/PLN were given at 8.15% (8.75% mid last week), 1 year EUR/PLN was given at 9.0%! (9.6% mid last week). The skew was also better offered, with currency spread (difference between USD/PLN and EUR/PLN) lower by 0.5%.

### Short-term forecasts.

Main supports and resistances

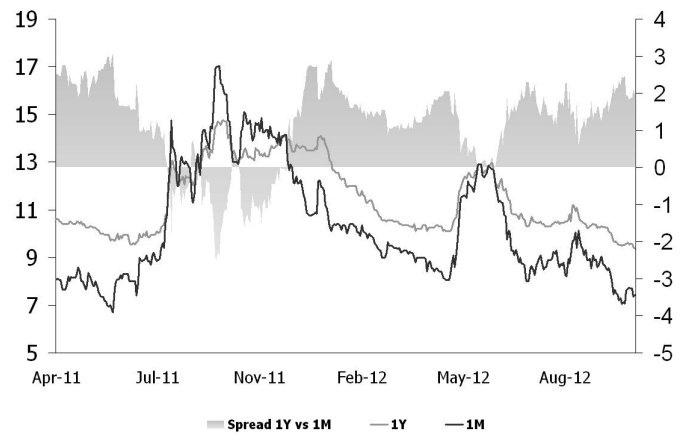
EUR/PLN: 4.0500 / 4.1800

USD/PLN: 3.1000 / 3.2500

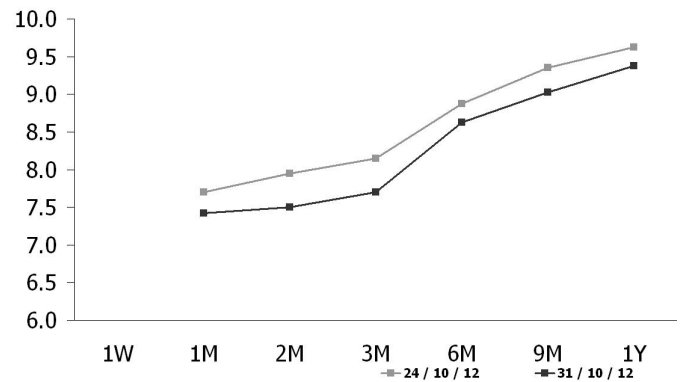
**Spot.** Play the range, allow same slippage on the borders, but have faith that the range is well in place. 4.15/4.17 sell levels with stop above 4.18 and hopes for 4.08, alternatively buy 4.06/4.08 with stop bellow 4.04 and eyes on 4.15. As it was already mentioned, we are trading water...

**Derivatives.** The sell off in the middle and backend 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 PLN may have from the Ministry of Finance (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
10/25/2012	4.51	4.75	4.53	4.65	4.46	4.65	4.50	4.17	3.83	3.73	3.77	3.85
10/28/2012	4.47	4.75	4.52	4.49	4.42	4.59	4.51	4.17	3.84	3.73	3.77	3.83
10/29/2012	4.45	4.75	4.48	4.64	4.42	4.63	4.51	4.17	3.84	3.74	3.79	3.84
10/30/2012	4.48	4.75	4.52	4.64	4.44	4.63	4.53	4.18	3.84	3.75	3.80	3.86
10/31/2012	4.52	4.73	4.49	4.63	4.41	4.62	4.50	4.17	3.84	3.75	3.78	3.84

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
10/25/2012	4.650	4.813	4.115	3.907	4.155	4.122	4.360	4.505
10/28/2012	6.590	4.813	4.110	3.897	4.150	4.139	4.340	4.529
10/29/2012	4.630	4.813	4.110	3.903	4.173	4.134	4.360	4.535
10/30/2012	4.630	4.813	4.134	3.913	4.185	4.123	4.370	4.621
10/31/2012	4.620	4.813	4.133	3.887	4.155	4.083	4.350	4.574

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/25/2012	7.73	8.00	8.83	9.55	9.55	3.46	0.75
10/28/2012	7.70	7.90	8.78	9.58	9.58	3.46	0.75
10/29/2012	7.70	7.95	8.78	9.58	9.58	3.45	0.75
10/30/2012	7.35	7.80	8.73	9.45	9.45	3.45	0.75
10/31/2012	7.43	7.70	8.63	9.38	9.38	3.46	0.75

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/25/2012	4.1430	3.1851	3.4240	3.9720	1.4822	0.1661
10/28/2012	4.1543	3.2119	3.4336	4.0158	1.4734	0.1666
10/29/2012	4.1472	3.2145	3.4310	4.0362	1.4652	0.1661
10/30/2012	4.1450	3.2036	3.4279	4.0337	1.4564	0.1657
10/31/2012	4.1350	3.1806	3.4249	3.9878	1.4580	0.1651

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