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Comment on the upcoming data and forecasts

Important releases next week. On Monday, the Central Statistical Office will publish the latest monthly figures from the labor market. We expect corporate employment to slightly decline annually - the slowdown in the real sphere should have influenced more industries and forced more enterprises to cut employment by now. Wages are likely to rebound somewhat from last week - mainly due to working day effects - but remain below inflation. On Tuesday, the CSO will release data on the industrial sector - here we expect a further decline in producer price index which can be associated with stable exchange rates and commodity prices, as well as low statistical base and lower firms' expectation. We also expect industrial production to slightly bounce back due to working day effect (we cannot forget that the underlying conditions have probably worsened). Finally, the Wednesday's release of core inflation data should confirm last weeks' CPI data and indicate that inflationary pressures are indeed receding.

Polish data to watch: November 12th to November 16th

Publication	Date	Period	BRE	Consensus	Prior
Corp. employment YoY (%)	19.11	Oct	-0.20	-0.10	-0.10
Corp. wages YoY (%)	19.11	Oct	1.6	2.4	1.6
PPI YoY (%)	20.11	Oct	1.5	1.6	1.8
Sold production of industry YoY (%)	20.11	Oct	1.7	2.8	-5.2
Core inflation YoY (%)	21.11	Oct	1.7	1.8	1.9

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 PS0418	-	4000	3.900	11/8/2012
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
Current account, CPI and M3 money stock figures released last week but mostly in line with analysts' expectations - next week is full of releases from the real sphere, the index is likely to resume its downward trend.

* 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 con-

Our view in a nutshell

Fundamentals

- Consensus view on the Polish economy still too optimistic (there were some minor revisions after NBP's inflation report). 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 2013 (gas price cuts announced in 1-2 months uderpin the scenario).
- MPC to apply proper easing cycle started already in 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

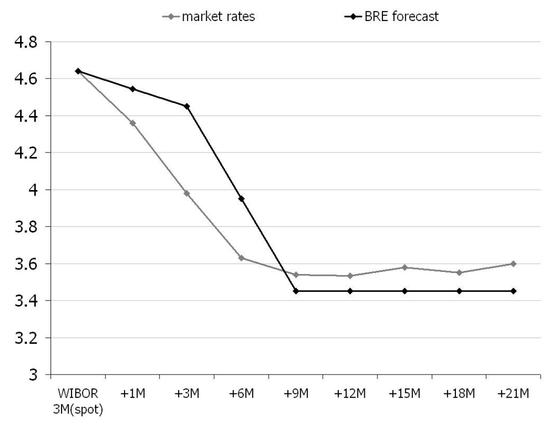
- Zloty moderately weaker towards the end of the year. Despite weaker economy and lower rates usual cyclical pattern for EURPLN set to be distorted by more balanced fiscal policy and accompanying lower current account deficit.
- Despite recent rally there is still room for lower rates in the short (monetary easing, carry trades) and the long end (mild risk-off supports Polish bonds, no signs of any credit risk rise in the next weeks, if not months. As the ongoing C/A rebalancing is rating positive, the process should prove positive for Polish bonds.).
- 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	3.70	3.50	3.50	3.75	3.80
10Y Polish bond yields (% eop)	5.50	5.15	4.69	4.20	4.00	4.20	4.50	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

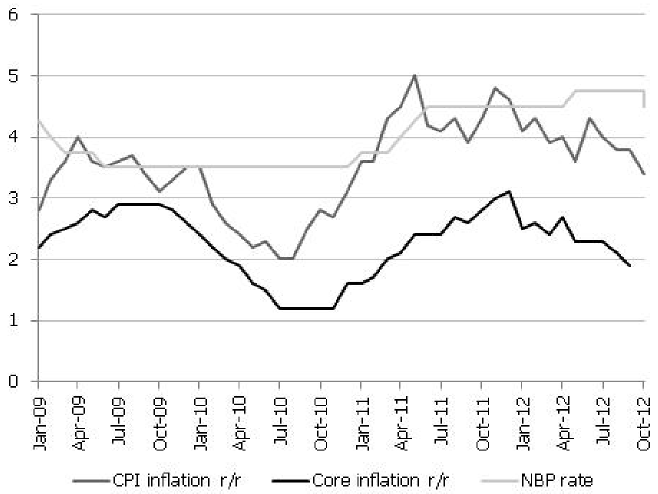


Economics

Inflation returns to NBP target band

Annual inflation rate declined in October from 3.8% to 3.4%. The drop in inflation was in line with analysts' consensus. On a month-to-month basis consumer prices grew by 0.4%.

There were no extraordinary price changes, therefore the decline in inflation rate is reflecting the emerging downtrend better and better. Significant price increases occured only in categories such as clothing and footwear (3.5% m/m) and food (0.6% m/m) but this fits the usual seasonal pattern. Core inflation net of food and energy is likely to have declined in October to 1.8% per annum.



The decline in annual inflation rate should continue in the coming months: in November and December inflation will drop to 3.1% and 3.0% per annum, respectively. High base effects from 2011, stronger PLN and stable fuel prices will contribute to this decrease. In the first quarter of 2013 inflation will likely drop below NBP's target of 2.5% y/y. Further declines will be determined by deteriorating economic conditions and the lack of energy price increases (high statistical base effects, again). We also predict that after January inflation will be revised downwards as new weights for the CPI basket are introduced.

The declining inflation, along with constantly deteriorating growth perspectives will influence MPC's stance (given that a significant portion of the Commitee is still concerned about inflation risks). Taylor rule based on forecasts from the latest inflation report suggests that there is enough space to cut interest rates by as much as 150 base points. We would also like to note that we are even more pessimistic with regard to economic growth and we expect inflation to decline even faster. Market expectations of rate cuts can thus be constantly stimulated by new economic releases. We also believe that the scenario assumed by the Commitee (see the latest statement of Mrs Zielińska-Głębocka) - that monetary easing cycle will stop at 3.75% - is unrealistic. The MPC might stop there only to be forced to cut even deeper due to economic conditions.

Governor Belka outvoted in October

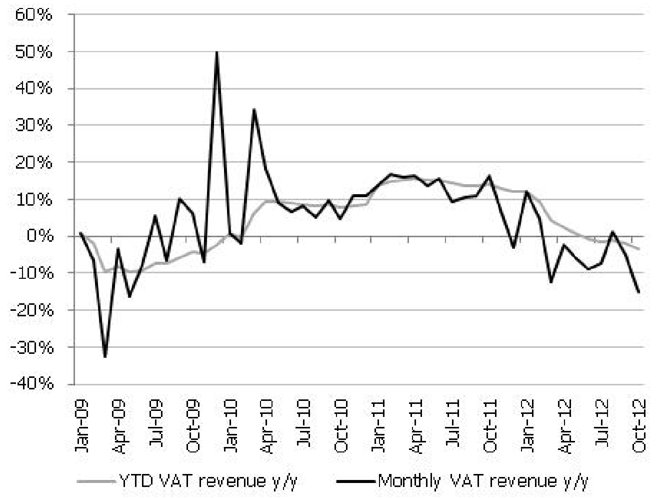
Minutes from October's meeting of the Monetary Policy Committee indicate that the motion to cut interest rates was rejected by a 5:4 majority. Marek Belka, the Governor was among those who supported the proposal and were outvoted. From a historical perspective, nothing extraordinary happened. Outvoting NBP governors is a Polish tradition. It has never resulted in resignations or sudden reversals in monetary policy. As of now, after the rate cut in November, the course of monetary policy is clear - an easing cycle has begun. Along with the details of the unfortunate vote, an interview with M.Belka was released. He confirmed the direction of monetary policy and that further cuts are coming. Moments later an interview with J.Hausner was pulished. Viewed as the swing voter, Mr Hausner probably carries the largest responsibility for the result of October's vote. Hausner singled out the inflation projection as the base for rate cuts and announced further cuts "rather sooner or later". Admittedly, he doesn't support "drastic" monetary easing but he is billing to change that stance if economic forecasts are revised downwards.

In an earlier interview A. Zielińska-Głębocka, a "born again dove", claimed that a total of 100 base points is an intended extent of interest rate cuts. This assumption, along with the current MPC's style of action (i.e. following the line, a term coined by Mr. Hausner) seems to be shared be the majority of MPC members. In our opinion, this pushes the Committee towards closed and unrealistic scenarios similiar to those from May. In the short run, such committments obviously Carnot be ignored. Thus, it is certain that rates will have been cut by 75 bps by the end of the first quarter. If we extend the time horizon of our analysis, differences between our scenario (our reasoning can be found in the November's BRE Macroeconomic Review) and the one assumed by the MPC must be taken into account. We expect that the next inflation projection will be revised downwards (in terms of economic growth and inflation Alice), forcing the MPC to reconsider an extention of interest rate cut cycle. This scenario should be confirmed by GDP figures for the third quarter - GDP probably grew by 1.5-1.6% per annum (the NBP assumes an increase by 1.8%) while growth rate of personal consumption dropped to 0.7% YoY (this figure in the NBP's projection equals 1.3%).

October's budget performance - a decline in VAT revenues confirms a deep slowdown

According to data published on Thursday, budget deficit amounted to 34.7 bn PLN as of October, compared with 22.1 bn at the end of September and 35 bn planned for the whole year. This increase has already been signalled in a preliminary press release from the Ministry of Finance and in statements of its officials. According to them, the surge in budget deficit is a consequence of shifts on the expenditure side: delays in some expenses and increased debt payments (which, in turn, should be very low in November and December).

Nonetheless, the revenue side is much more interesting from our point of view, as its performance reflects the state of the real economy. Admittedly, total revenues are right on schedule but tax revenues collected in the first 10 months of the year amount to 77.6% of the plan (in the previous two years this indicator equalled 81-83%; furthermore, if we assume an equal distribution of tax income along the year, a 83.3% is expected). Even more worrying is the decline in VAT income. The revenue collected in October is roughly 15% down from last year on a monthly basis and 3.2% on a year-to-date basis. These is the sharpest decline since mid-2009 and if the current actual-to-planned ratio will hold in the last two months, a total of 20 bn PLN will be missing. The mystery of relatively good performance of total budget income is NBP's profit of 8 bn PLN which wasn't even in the schedule. If not for this unexpected gift, the deficit would have exceeded 40 bn PLN by now.



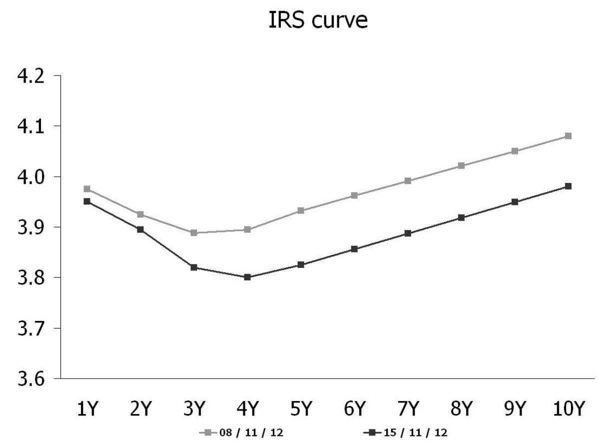
As a result, given the fears of rising public debt and a push for leaving the Excessive Deficit Procedure, expressed by the Ministry of Finance, one cannot expect the budget deficit to exceed assumed levels. With the widening tax revenue gap, adjustments will have to take place on the expenditure side. Thus, in the last quarter of the year we will observe a de facto fiscal tightening. This will further depress the already sluggish internal demand and only deepen the coming economic slow-down. Such a scenario reinforces our forecast for the first half of 2013 (i.e.: a recession).

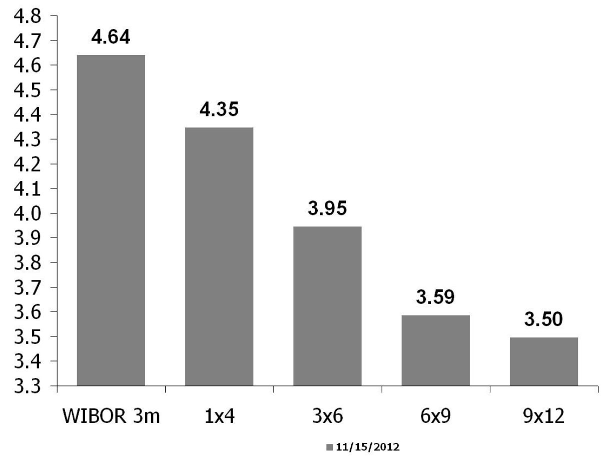
On the other hand, we ought to remember that financing for the deficit is secured - as of now 20% of next year's loan needs has been prefinanced. Record lows in Polish treasuries also means that new debt will be released at a significantly lower cost.

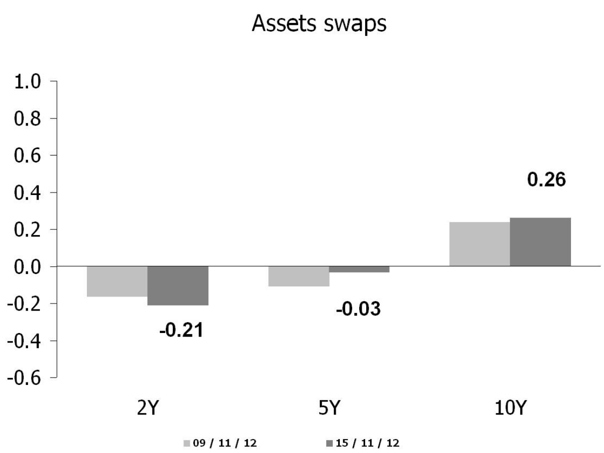
Fixed income

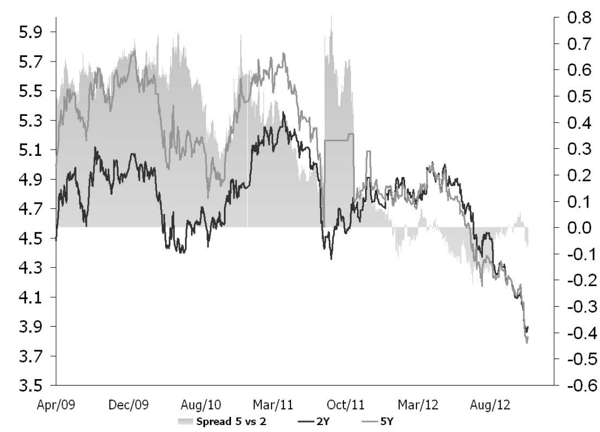
The rally has (finally) stopped.

The quite extreme rally on Polish bonds that we observed for the past couple of weeks seems to have finally reached some exhaustion point. Bond market seems a bit more balanced here with mixed interest and finally some real flow to sell. Rates have also rebounded from recent lows by few bps. Recent comments from MPC members were generally dovish, however very mixed with calls varying from cautious approach (Winiecki) to quite extreme cuts (deeper than 175bp in total - Chojna-Duch). Outvoting Governor Belka during October's meeting also confirms that rate path isn't really decided yet (apart from another 75bp cuts which are likely to be delivers within next few months). If market continues to consolidate on current levels, some correction in rates is likely, however we don't think it could be significant. Next macro data will keep confirming slowing CPI and pointing to a slowdown deeper than current market consensus. That should make the MPC even more dovish and likely increase easing expectations even further, be it the total amount or pricing cuts by more than 25bp at a time. We already thought a while ago that the rally had been approaching an end but apparently it's still too early to be negative on rates here.



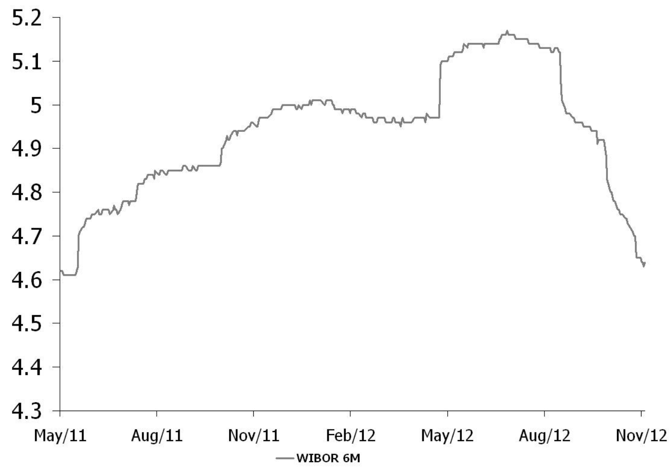


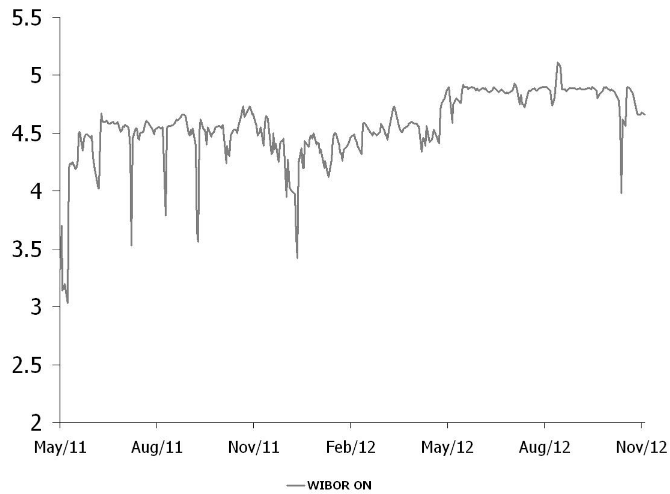


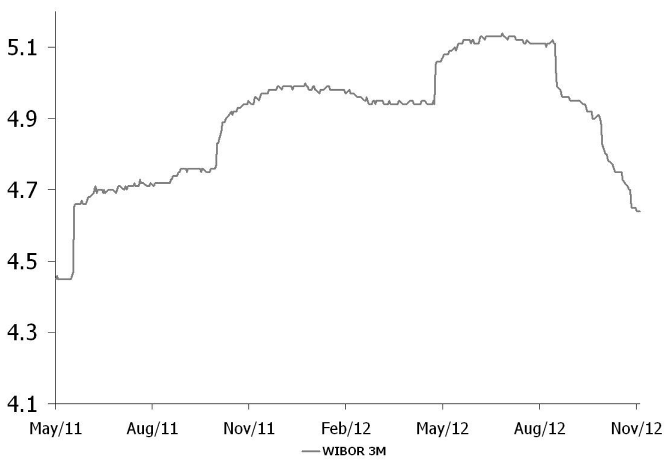


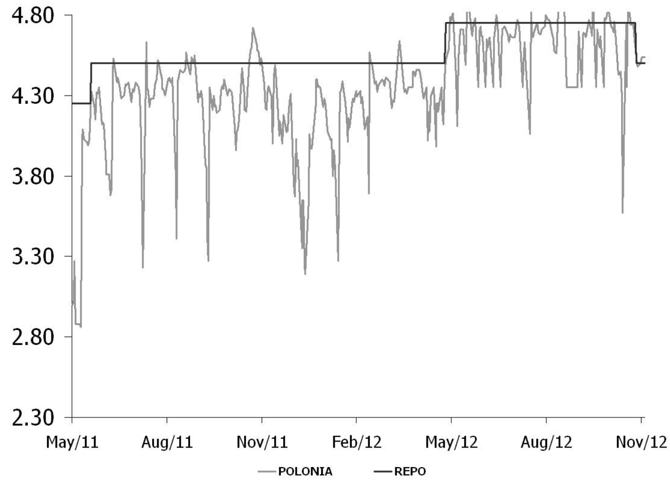
Money market

Figures on the bulls' side Shortest rates stable all week and they should stay that way in the coming days. After today's OMO (105.5 bln pln) market is going to be a bit long, however reserve requirements seem to be underbuilt, which in turn allows for smooth absorption. CPI in line with expectations at 3.4% proving that the pressure goes away. Next week we have another set of figures, all expected to support the bulls. Market has already priced in another 125 bps cut coming in the very next months, and as of now we still do not see any incentives that could change that scenario. Timing play and/or one step scale has still value on this market. In the meantime we can observe as MPC members and the street change the rhetoric towards our base scenario which is: interest rate cuts faster and deeper than in the consensus scenario. Nonetheless, at the same time the market plays our scenario very efficiently.







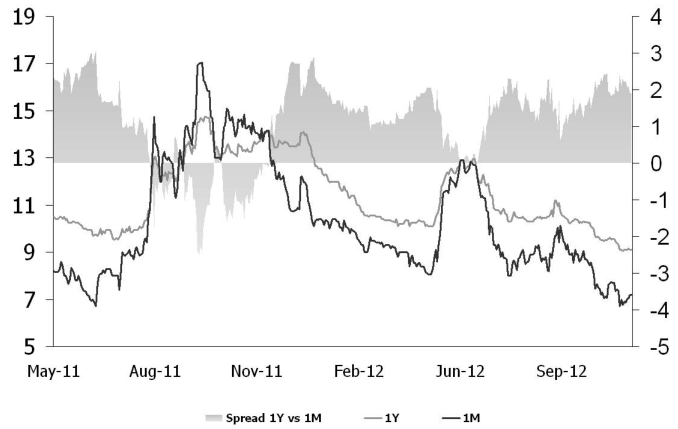


Forex

4.20 resistance unscratched The 4.1925 was of the high of EUR/PLN this week. The 4.20/4.22 resistance zone was not even properly tested, and we are now back in the middle of the range. The 4.10/4.12 constitutes support, and the market is slow and boring. The rates cuts were not able to weaken Złoty significantly as there is a huge appetite for PLN bonds. There is little reason for EUR/PLN to fall bellow 4.10 as the general investment mood is still bit shaky. We need a strong impulse to break out of the current well-defined range and we don't see such a thing on the horizon...

Volatility lower again. The correction higher from the post-Lehman lows was really shot lived. As we have stepped back from 4.20, the 6 month EUR/PLN was given at 8.2%, the short end was also sold heavily. As the result the EUR/PLN vol curve is back at it lows with 1m ATM mid EUR/PLN at 7%, and 1y ATM at 9%. The skew was better offered as well roughly by 0.25% and currency spread (deference between USD/PLN and EUR/PLN was lower by 0.5% or even 0.75% in the frontend).

EURPLN volatility



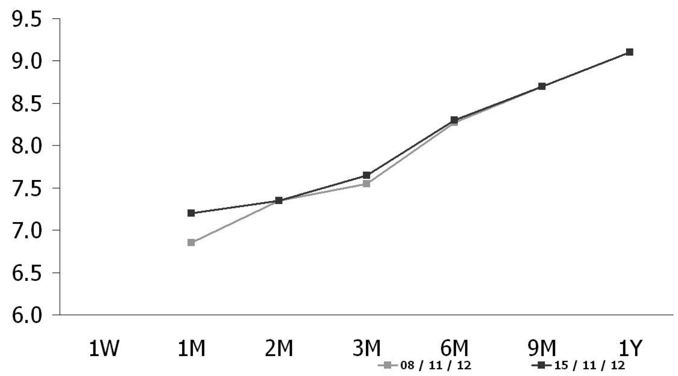
Short-term forecasts.

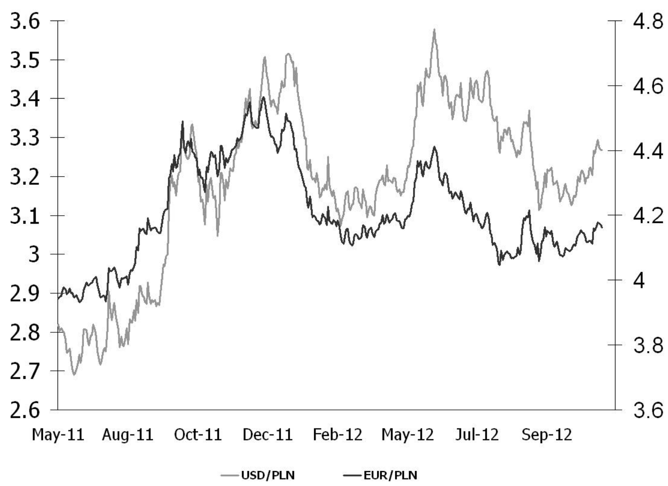
Main supports and resistances
EUR/PLN: 4.0500 / 4.1800
USD/PLN: 3.1000 / 3.2500

Spot. Play the range, allow same slippage on the borders, but have faith the range is well in place. 4.18/4.19 is a sell zone with a stop above 4.2050 and hopes for 4.14. Or alternatively 4.11/4.12 it s a buy zone with a stop bellow 4.0950 and eyes on 4.17.

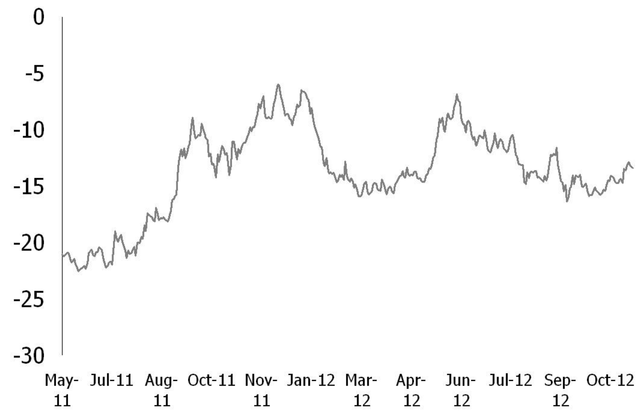
Derivatives. The XXX/PLN vols are back at their post-Lehman lows, but the realized volatility is not really encouraging buyers. I think we should stay sidelined for the time being, the picture is blurred and the end of the year is so close, profit protection is a obvious strategy.

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
11/9/2012	4.44	4.65	4.44	6.49	4.44	6.59	4.38	3.93	3.57	3.49	3.53	3.57
11/12/2012	4.45	4.65	4.30	4.55	4.20	4.54	4.37	3.93	3.56	3.47	3.53	3.58
11/13/2012	4.35	4.64	4.28	4.54	4.13	4.53	4.37	3.92	3.55	3.46	3.51	3.52
11/14/2012	4.38	4.64	4.31	4.54	4.23	4.53	4.38	3.93	3.58	3.50	3.51	3.60
11/15/2012	4.35	4.64	4.34	4.53	4.26	4.52	4.35	3.95	3.59	3.50	3.52	3.60

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
11/9/2012	6.590	4.813	3.888	3.726	3.835	3.727	3.940	4.179
11/12/2012	4.540	4.813	3.860	3.722	3.810	3.756	3.940	4.191
11/13/2012	4.530	4.813	3.860	3.744	3.800	3.765	3.955	4.187
11/14/2012	4.530	4.813	3.865	3.682	3.785	3.771	3.945	4.201
11/15/2012	4.520	4.813	3.895	3.687	3.825	3.794	3.980	4.242

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
11/9/2012	7.05	7.70	8.28	9.10	9.10	3.46	0.77
11/12/2012	7.05	7.70	8.30	9.15	9.15	3.46	0.77
11/13/2012	7.20	7.65	8.30	9.10	9.10	3.45	0.76
11/14/2012	7.20	7.65	8.30	9.10	9.10	3.45	0.76
11/15/2012	7.20	7.65	8.30	9.10	9.10	3.33	0.76

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
11/9/2012	4.1527	3.2588	3.4418	4.1061	1.4622	0.1638
11/12/2012	4.1661	3.2803	3.4565	4.1277	1.4699	0.1645
11/13/2012	4.1782	3.2945	3.4688	4.1556	1.4670	0.1645
11/14/2012	4.1754	3.2750	3.4685	4.0977	1.4653	0.1640
11/15/2012	4.1712	3.2678	3.4639	4.0405	1.4615	0.1640

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