BRE BANK SA

POLISH WEEKLY REVIEW

December 2, 2011

Bureau of Economic Analysis
(research)

Ernest Pytlarczyk, PhD, CFA
chief economist
tel. +48 22 829 01 66
ernest.pytlarczyk@brebank.pl

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@brebank.pl

Paulina Ziembinska
analyst
tel. +48 22 829 02 56
paulina.ziembinska@brebank.pl

Artur Płuska
analyst
tel. +48 22 526 70 34
artur.pluska@brebank.pl

Financial Markets Department
(business contacts)

Lukasz Barwicki
head of trading
tel. +48 22 829 01 93
lukasz.barwicki@brebank.pl

Inga Gaszkowska-Gebska
institutional sales
tel. +48 22 829 01 67
inga.gaszkowska-gebska@brebank.pl

Bartlomiej Malocha, CFA
money market
tel. +48 22 829 01 77
bartlomiej.malocha@brebank.pl

Jaroslaw Stolarczyk
structured products
tel. +48 22 829 01 67
jaroslaw.stolarczyk@brebank.pl

Marcin Turkiewicz
fx market
tel. +48 22 829 01 67
marcin.turkiewicz@brebank.pl

Reuters pages:
BREX, BREY, BRET

Bloomberg:
BRE

SWIFT:
BREXPLPW

BRE Bank S.A.
18 Senatorska St.
00-950 Warszawa
P. O. BOX 728
tel. +48 22 829 00 00
fax. +48 22 829 00 33
http://www.brebank.pl

Table of contents

Comment on the upcoming data and forecasts

On Wednesday MPC will announce its interest rate decision. Given the recent comments by Kaźmierczak we cannot exlude that there will be submitted a rate hike motion. The motion has meager chances of success, though. We think the MPC is stuck somewhere around neutral stance. On the one hand it cannot embark on tougher policy since most of the members are aware that the economy is slowing down and such a move may beat down fledgling private investment. On the other hand, high inflation and FX interventions policy does not support an abrupt switch to easier policy.

Polish data to watch: December 5 to December 9

Publication	Date	Period	BRE	Consensus	Prior
MPC interest rate decision	7.12	Dec	4.5	4.5	4.5

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Last yield (%)	Prev auction
52 Week T-bills	-	600	4.578	5/30/2011
2Y T-bond OK0114	-	3000	4.469	8/10/2011
5Y T-bond PS1016	-	2500	5.147	11/16/2011
10Y T-bond DS1021	-	3000	5.803	7/21/2011
20Y T-bond WS0429	-	250	6.246	1/12/2011

Macroeconomic forecasts

Wskaźnik	2008	2009	2010	2011 F	2012 F
GDP y/y (%)	5.1	1.6	3.8	4.0	2.8
CPI Inflation y/y (average %)	4.3	3.5	2.8	4.2	3.6
Current account (%GDP)	-5.3	-1.6	-4.5	-4.9	-3.6
Unemployment rate (end of period %)	9.5	12.1	12.4	12.6	12.8
Repo rate (end of period %)	5.0	3.5	3.5	4.5	4.0

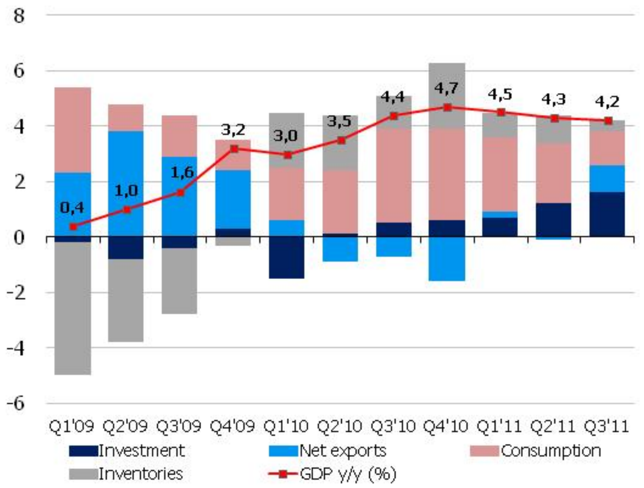
	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4 F
GDP y/y (%)	4.4	4.7	4.5	4.3	4.2	3.6
CPI Inflation y/y (average %)	2.6	2.9	3.7	4.2	4.1	4.4
Repo rate (end of period %)	3.5	3.5	4.0	4.5	4.5	4.5

F - forecast

Economics

GDP surprises positively, again!

3Q GDP increased by 4.2% y/y after 4.3% in the previous quarter. Detailed examination of GDP growth decomposition exerts rather positive impression. First of all, one should note that relatively high GDP growth was generated despite negative contribution of public consumption (ca. -0.6 pp.). As for other components, in line with our expectations consumption growth decreased (from 3.6% to 3.0%). Surprisingly higher turn out to be the growth pace of investments (from 6.9% to 8.5%). Taking into account correlation factor between investments and construction sales (which indicated the slump on private investments) these data suggest that component connected with business equipment gained on momentum. Therefore endogenous investment cycle is continued even despite the lower share of infrastructure investments. Inventories added 0.4 pp. to growth and net exports contributed at the level of +1 pp. once again proving its counter-cyclicality.

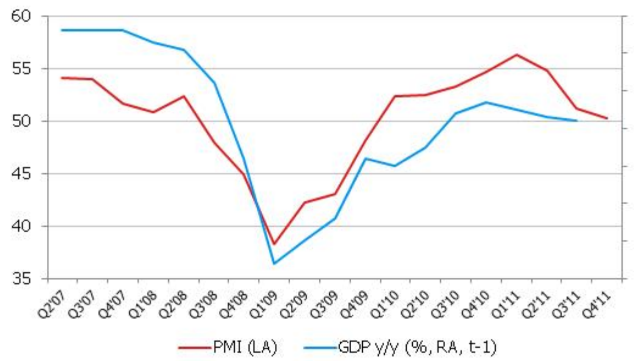


On the supply side, gross value added in industry was sustained at ca. 5-6%, gross value added in construction sales decreased. In other categories there were no significant changes, GVA growth was close to previous readings or slightly higher.

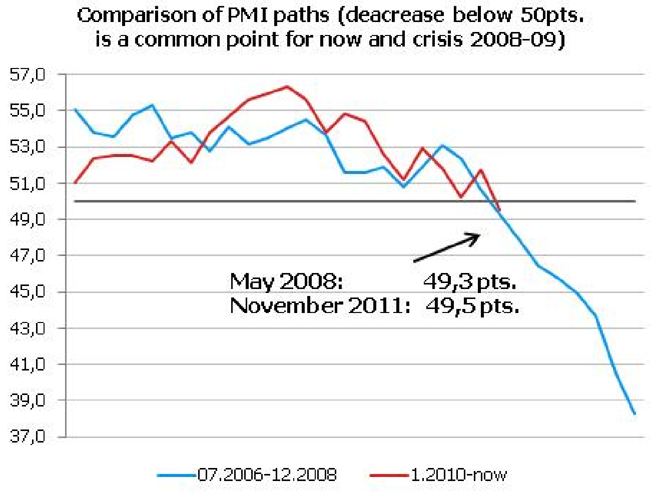
Announced data show that we might have properly identified mechanisms ruling the current business cycle. First of all, we recognize negative influence of shocks imposed on consumption (exchange rate shock, inflation shock), which along with rising saving attractiveness (interest rates rise because of starting „deposit wars") are set to intensify. However, we do not expect lower consumption growth than recorded in 2009, because of relative better situation on the labor market. Secondly, worsening correlation between value added in construction and fixed capital formation proves well for the continuation of the cycle (no sudden stop scenario). Even if infrastructure investment turns out to be lower in 2012 (an argument which we do not believe in by the way), investment should be supported by private companies'. Moreover, expected increase of household deposits growth rate and decrease of credit to deposit ratio in banking sector give an opportunity for increase in corporate loans. Finally automatic stabilizers are coming on; after decrease in consumption and sustained price competitiveness of Polish exports (lagged effects of weaker exchange rate) it should lead to higher contribution of net exports and maintain GDP growth in 2012 at close to 3%.

PMI published, what is in the cards afterwards?

PMI fell from 51.7pts. to 49.5pts., signaling an overall worsening of business climate for the first time since October 2010. Driving the downturn in November was a decline in new orders (third time in a row and fastest since July 2009) and new export orders deteriorated sixth month in a row. Production almost stagnated over the month, the flat trend in output influenced firms' hiring (employment increased, but at a weak rate) and purchasing decisions in November. Upward pressure on manufacturers' input prices attributed to weak zloty remained stubbornly high and was partly passed on to clients in the form of higher output prices (although inflation eased to a modest pace).



PMI decreased below theoretically important threshold of 50pts. What is more, historical analysis implies that after few months of fluctuations (contrary to PMIs in Germany and euro zone drawing visible downward trend, in Poland path wasn't clear e.g. with one-off in October) index is to stay below 50 pts. for longer (since June 1998 the shortest sequence below 50 pts. lasted for 5 months, while during crisis in 2008-09 it was 18 months). The trajectory visible when overlaying breakdown points from May 2008 and now (see chart) points to downside risks going forward. But as the direction itself was quite obvious, it is the strength of deterioration that is more interesting. We expect slow-down to be weaker than the one from 2008, while most factors are imported and domestic market stays strong, owing the relative short expansion phase did not stood up to generate as many imbalances as it did during 2006-2008 prosperity period. What is more, the starting point of Polish economy with weaker zloty, only recently started investment cycle and self-adjusting labor market (better liquidity situation in companies, more elastic forms of employment) is much better than in 2008.



After the weaker PMI reading there is a risk of lower industrial output and retail sales (our previous calls for accordingly 6.0% y/y and 10.6% y/y). Continuing with real sphere, softer employment indicators suggest a forecast of monthly drop of 9-10k worker is to the point; hence we do not change our employment call, currently at 2.3% y/y for November. Switching to nominal sphere, we expect quite decent inflation reading (4.7% y/y) driven by food prices and gas fuels; recent surprisingly high inflation expectations suggest that something (i. e. something clearly pro-inflationary, at least in November) may be in the cards since normally inflation expectations follow the movement from previous CPI readings. Also PPI reading may prove higher than last month, we feel quite confident on our call for a 8.7% y/y rise. Last, but no least, wages should ease bit below 5% y/y but not owing to weaker growth in manufacturing, but to base effects in mining connected with seasonal shifts in bonus payments.

Because of a possibly shocking reading of CPI about which - owing to NBP expert forecasts - MPC may know in advance, and given recent comments of Kaźmierczak, we cannot exclude a motion for a hike but, given the deterioration in PMI index (which will not escape MPCs attention since it missed the crucial 50pts level), it has very little chance of success. The MPC seems trapped at the moment in neutral stance. On the one hand it cannot embark on tougher stance since most of the members are aware that the economy is slowing down in the future and such a move may beat down fledgling private investment. On the other hand (damn two-handed economists. . .), high inflation and FX interventions policy does not support an abrupt switch to easier policy. We think that the widow of opportunity for rate cuts opens in H1 2012 when inflation eases closer to the target and softer growth of the Polish economy can be felt in Q4 GDP data.

Fixed income

Negative sentiment on a local FI market vanished. Possible CPI soar to 4.6%-4.7%.

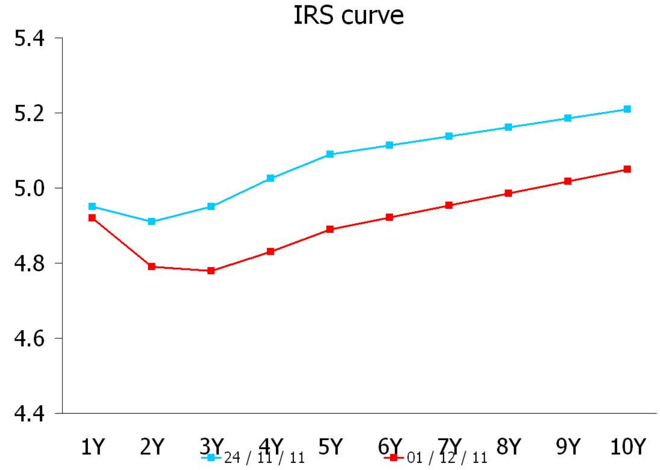
The negative sentiment on a local FI market has vanished. After we had tested the highest levels on a IRS curve since the late July, the market reverted rapidly by 30-35 BP within a few days. As a direct result of coordinated monetary easing by the major world central banks the real flow to receive 5Y PLN sector pushed the 2y5y spread down to 8-10 points and the 5Y IRS down to 4.90% from 5.25% traded last Friday. The better mood on a global markets would likely be supported by the EU conference on December 9th where the further steps towards healing the crisis cancer were strongly expected. If the EU rulers succeeded to work up an adequate measures to reassure the investors of the further Union stability, the bullish trend could be continued.

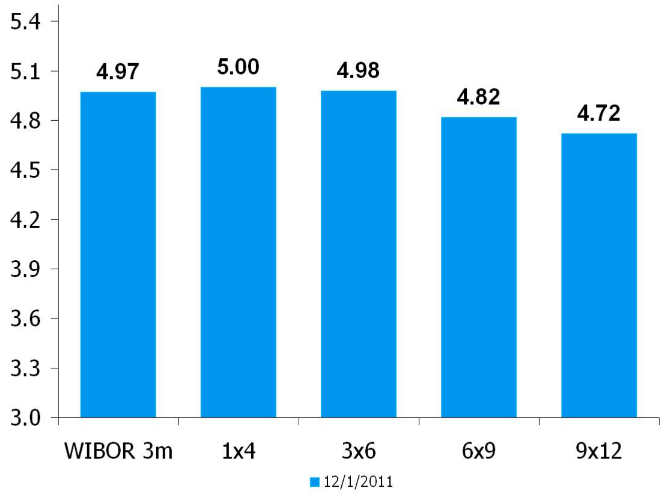
And now, for something completely different... more scary one. According to the recent real economy data our it is possible that CPI inflation will hit 4.6%-4.7% with the more risk of 4.7%. That number might change the whole our strategy for the end of 2011 and the first half of 2012. Few important matters should be considered if that figure materializes on December 13th. According to the recent comments coming from the MPC members about the necessity of a further policy tightening when CPI trend reverts, such a high inflation reading cannot be ignored. Moreover, it is very likely the MPC should be familiar with a matter during the next decisive meeting on December 6th -7th. It's out of a question then, the motion of a rate hike would be submitted. Would it be successful?

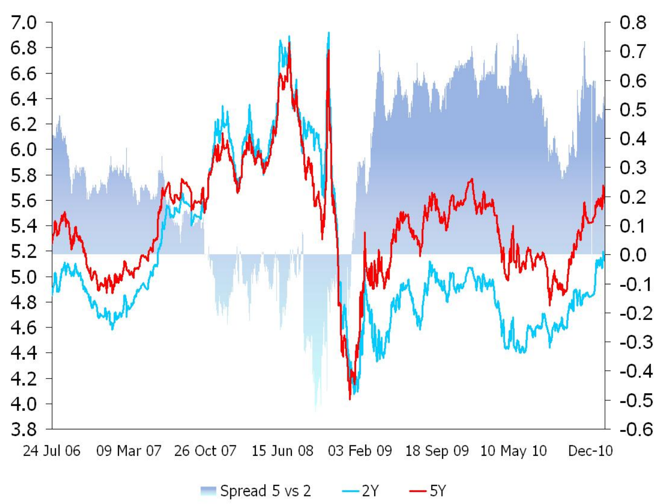
The CPI surge results mainly from the FX rate level. Having followed the last interventions on a FX market, it looked clear the Central Bank failed to curb the constant PLN depreciation. That proved to be clear such an action that was non-effective and very costly as FX reserves shortened without any visible result. Trying to conclude all that facts, rate hike could be a viable equivalent. The higher disparity in rates (ECB is said to cut rates in December) would struck down all speculative moves on PLN moving the FX rate down rapidly that would result in debt-to-GDP ratio falling down to the comfortable levels and revert the CPI uptrend. Moreover, it would definitely support the longer end of a yield curve that might result in lower budget financing costs next year. At the end, it couldn't be any harm for the economy as the Wibor rates have already went up by 20-25points above their fair value and the impact of a potential rate hike is likely to be limited.

Such a scenario has also important shortcomings. It entails probably a hike of more 25bps which would tear down investment cycle, and it would not erase the change of the structure of the flows, only deter a bunch of speculative players, the majority - given their possibly 50 figure profits - will stay there. Moreover, the MPC does not want to mimic NBH, and such a move would be read like the MPC has changed the attitude. And to conclude, the MPC probably has in mind the mistake of ECB policy from 2008 when it raised rates and is aware that PMI reading below 50pts does indeed herald move downwards in the real sphere.

Therefore the probability of such scenario is limited and the MPC would not be likely to take a non-standard actions and would probably prefer to wait for the market to rationally solve the matter itself, the rate hike will be voted in December for sure. Anyway, as the business year is about its end and our risk appetite is quite smaller, we try to pay the front end of a curve (1y3s) and buy 5Y bonds at least as a spread for despite the failure of tightening in December the probability of a rate hike would likely re-emerge once again in January.





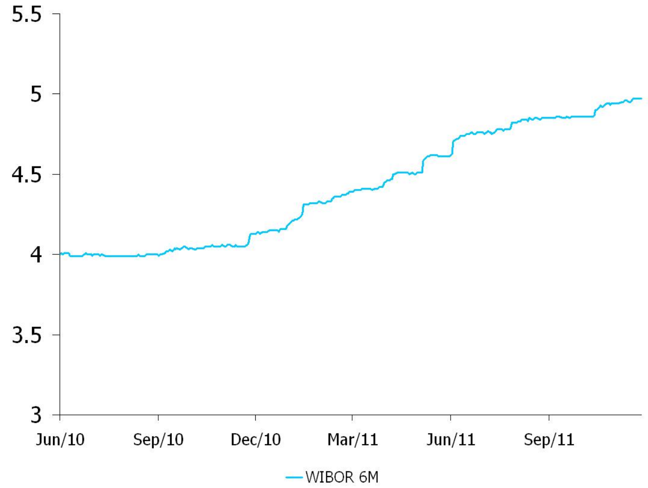


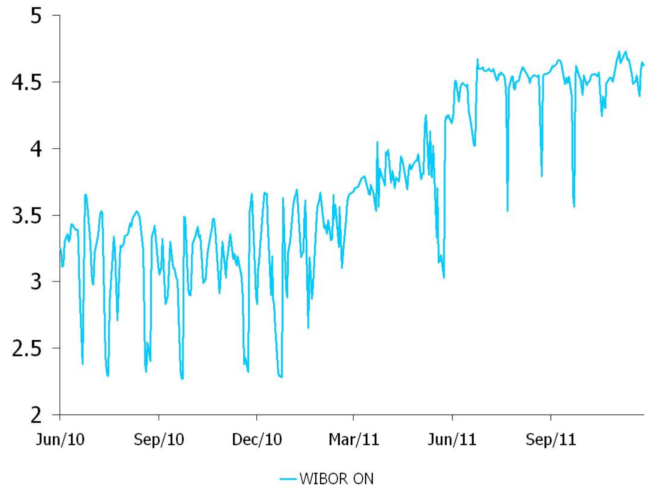
Money market

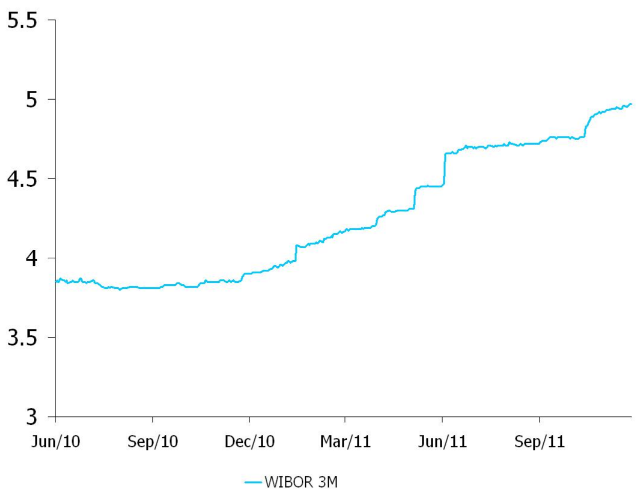
Will December be a cheap month? Stronger currency means lower front end.

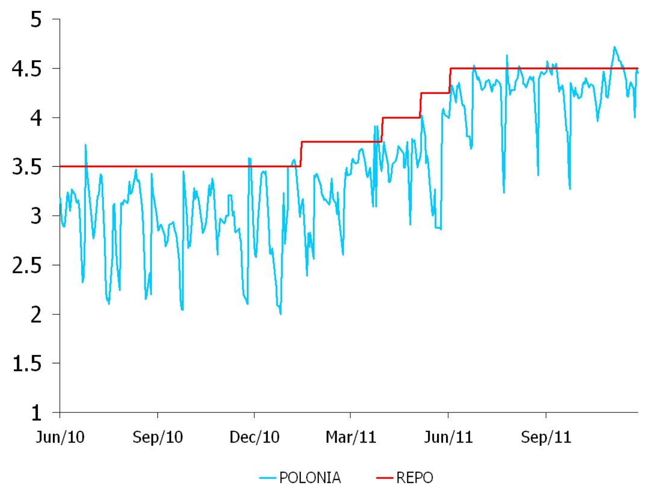
The new reserve settlement period started classically with the shortest rates nearby the main market rate. Since December was historically cheap due to increased risk aversion linked to holiday and the year end period, we see high probability of similar scenario this year. It has been supported today by the much smaller demand during the regular OMO (83.7 billion money bills bought out of 91.5 billion offered). Nonetheless, this will be corrected on Tuesday during the very likely additional OMO.

On the other hand, since some interest for obtaining cash for the year break (window dressing of the liquidity ratio), we also see the space for the wibor up to 1M to go up. All in all we see polonia index going down and the short wibor going up.
Better then expected GDP figure and lower inflation expectations was not reflected by the market. However, better global sentiment (small rally on equities) has strengthen the currency, which in turn pushed the front end of the yield curve nicely down. We do not expect that the MPC will change the rates this year, therefore further movements will still be globally driven.





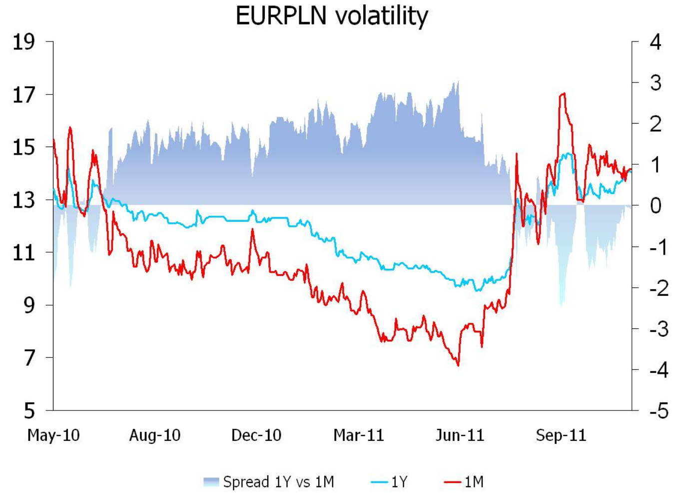




Forex

Higher in the range The new high was set at 4.5575 on EUR/PLN this week, on the back of global turbulences. The set of positive news, from China and most of all the coordinated intervention from 5 world's biggest Central Banks to cut the cost of borrowing in USD, changed the global sentiment and the EUR/PLN direction in seconds. The EUR/PLN collapsed to 4.4750 (the BGK has helped the move by selling USD on the market). Is it a mere correction in the trend, or the trend reversal is a main question now...

Vols consolidating The higher levels in EUR/PLN provoked fresh bids in the backend of the curve. The 6 month and 1 year was bid at 14.00. The frontend was well offered and the 1w has dropped to 12.00% given at the end of the week (beside the quite volatile historic at 13.75% week). The currency spread (deference between EUR/PLN and USD/PLN) was down to 10.25 from 10.75 last week and risk reversals were sold by around 0.25%. The market is very thin and we do not expect that to change till the new year.

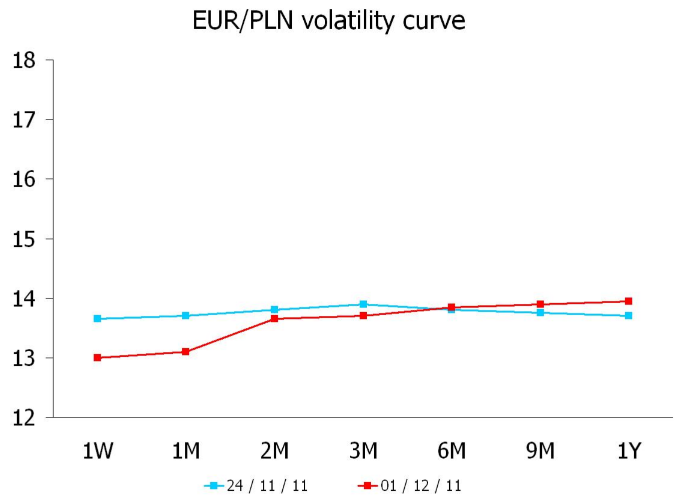


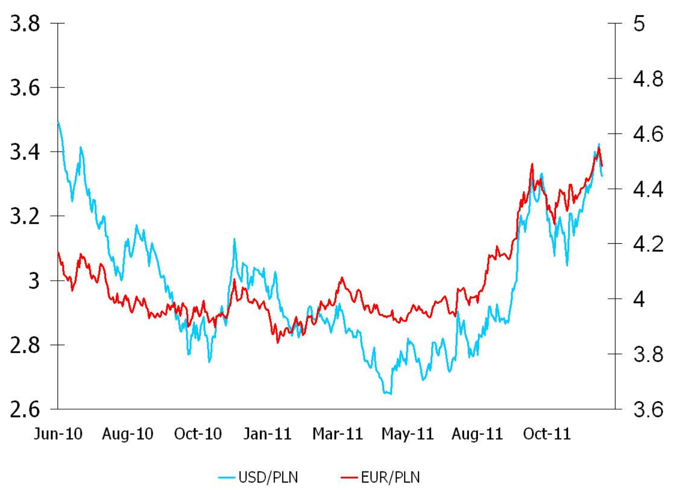
Short-term forecasts

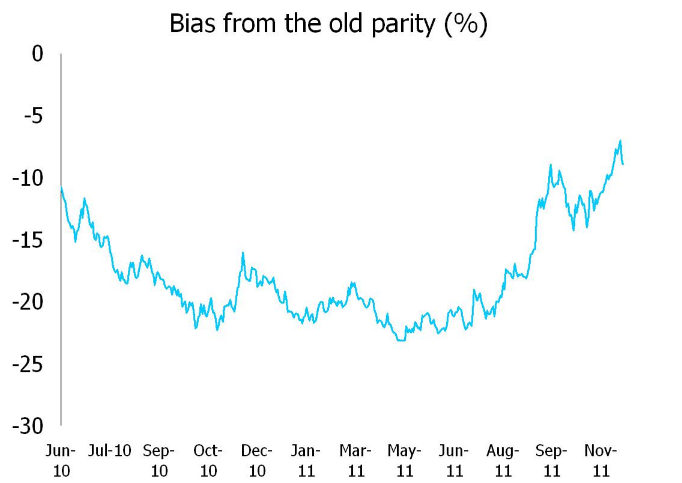
Main supports and resisances
EUR/PLN: 4.4300 / 4.6000
USD/PLN: 3.2500 / 3.5000

Spot. The wide range of 4.4300-4.6200 is still intact. We would play it opportunistically and be very disciplined with executing stop losses as the thin liquidity may create market gaps. Stay sidelined or exploit the extremes.

Derivatives. We are core long 3/6 months sector in ATMS in EUR/PLN. The short dated gamma we have bought last week paid its Theta bill with a small profit but we are letting it expire and not adding more gamma to the book. Would like to average Vega bellow 13%, but we doubt we will have this opportunity this year. Poor liquidity and wide spreads are the things we better get used to in current environment.







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
11/25/2011	4.77	4.96	4.96	6.49	4.81	6.59	5.00	5.01	4.87	4.79	4.84	4.94
11/28/2011	4.77	4.95	4.81	4.87	4.81	4.86	4.99	5.02	4.88	4.79	4.77	4.89
11/29/2011	4.75	4.96	4.94	4.87	4.80	4.87	4.99	5.02	4.85	4.76	4.76	4.89
11/30/2011	4.76	4.97	5.15	4.87	4.85	4.87	5.00	5.02	4.87	4.71	4.62	4.81
12/1/2011	4.80	4.97	4.98	4.87	4.83	4.87	5.00	4.98	4.82	4.72	4.60	4.84

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
11/25/2011	6.590	4.425	4.920	5.002	5.093	5.485	5.218
11/28/2011	4.860	4.425	4.910	4.971	5.050	5.418	5.190
11/29/2011	4.870	4.425	4.905	4.994	5.050	5.413	5.200
11/30/2011	4.870	4.425	4.800	4.892	4.890	5.254	5.060
12/1/2011	4.870	4.425	4.790	4.922	4.890	5.298	5.050

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1M	1Y
11/25/2011	14.10	14.05	14.05	14.05	14.05	5.03	0.44	0.70
11/28/2011	14.10	14.05	14.05	14.05	14.05	5.03	0.44	0.70
11/29/2011	14.15	13.85	14.00	14.10	14.10	5.03	0.43	0.65
11/30/2011	14.15	14.05	14.05	14.05	14.05	5.03	0.44	0.70
12/1/2011	13.10	13.70	13.85	13.95	13.95	5.03	0.74	0.70

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
11/25/2011	4.5130	3.4001	3.6739	4.3937	1.4269	0.1745
11/28/2011	4.5071	3.3705	3.6654	4.3329	1.4586	0.1748
11/29/2011	4.5282	3.3924	3.6789	4.3538	1.4638	0.1772
11/30/2011	4.5494	3.4248	3.7112	4.3909	1.4603	0.1779
12/1/2011	4.5083	3.3400	3.6741	4.2965	1.4859	0.1779

Disclaimer