BRE BANK SA

POLISH WEEKLY REVIEW

January 27, 2012

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Comment on the upcoming data and forecasts

On Thuesday inflation expectation will be published. It may hit 5.5% against 4.8% in December. Such high reading will inflate market expectations on interest rates hikes. On Wednesday Polish PMI will be published. PMI may follow reading from Germany and euro area and suprise to the up-side.

Polish data to watch: January 30 to February 3

Publication	Date	Period	BRE	Consensus	Prior
Inflation expectation y/y (%)	31.01.	Jan	5.5		4.8
PMI	01.02.	Jan			48.8

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Last yield (%)	Prev auction
52 Week T-bills	1/30/2012	2000	4.520	1/9/2012
2Y T-bond OK0114	3/14/2012	6000	4.724	1/19/2012
5Y T-bond PS1016	2/9/2012	4000	5.246	10/16/2012
10Y T-bond DS1021	2/16/2012	3000	5.803	1/12/2012
20Y T-bond WS0429	2/16/2012	3600	5.931	1/12/2011

Macroeconomic forecasts

Wskaźnik	2008	2009	2010	2011	2012 F
GDP y/y (%)	5.1	1.6	3.8	4.3	2.8
CPI Inflation y/y (average %)	4.3	3.5	2.8	4.3	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	12.5	13.6
Repo rate (end of period %)	5.0	3.5	3.5	4.5	4.0

	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1 F	2012 Q2 F
GDP y/y (%)	4.5	4.3	4.2	4.0	3.6	3.0
CPI Inflation y/y (average %)	3.7	4.2	4.1	4.6	4.1	3.7
Repo rate (end of period %)	4.0	4.5	4.5	4.5	4.5	4.5

F - forecast

Economics

Now it is a majority of MPC members that consider rate hikes

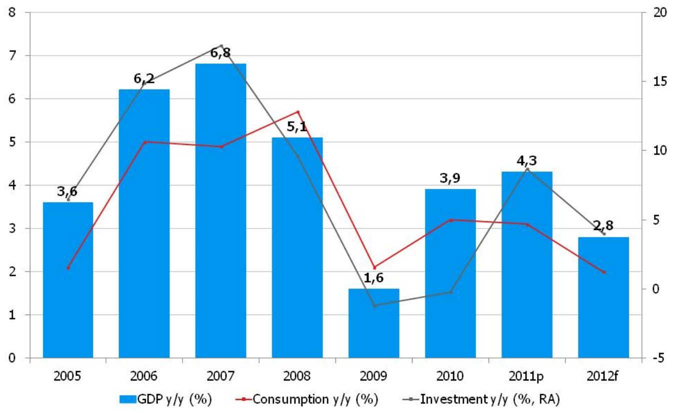
January's MPC meeting „Minutes" showed significant change in MPC's assessment of current economic situation in Poland. MPC members treated economic perspectives with great optimism indicating simultaneously good recent macroeconomic data and continuation of credit market recovery. The majority of MPC members affirmed that economic slowdown in Poland will be weaker than previously expected. GDP growth will also be resistant on the slowdown in Europe. Besides optimistic economic growth expectations, MPC members expressed worries about high inflation, especially after November reading at 4.8%. A significant upside revision of inflation forecasts for 2012 was noted, along with the fact that inflation expectations are on the rise (the same argumentation that led to interest rate hikes in 2011). Contrary to previous MPC meetings it is not „a few" but now a „majority" of MPC members that indicates the possibility of interest rates hikes. Such scenario is directly determined by the case of slight decrease of economic activity and simultaneous lack of visible downside trend of inflation. The end of downside forecast revision for euro zone will also be additional important factor in favor for monetary policy tightening.

Polish macroeconomic data in forthcoming period may further heat up expectations towards interest rates hikes. After the last decreases, Polish PMI index will probably rebound, what will follow last increases of its counterparts in Europe and Germany. Moreover, expected inflation decrease in January will rather be symbolic. Next NBP's inflation projection should show higher GDP growth in 2012 and 2013, what will boost further expectations towards interest rates hikes.

Significant PLN exchange rate appreciation and explicit inflation decrease after February will dampen MPC wording on monetary policy tightening and will make a scenario of prolonged period without interest rates changes more probable. However, still a motion for interest rate hikes cannot be excluded during the next MPC meeting (or on March).

GDP growth at 4.3% in 2011

In 2011 GDP grew by 4.3% y/y. It means in Q4 2011 GDP growth pace would have amounted to more than 4.1% y/y.



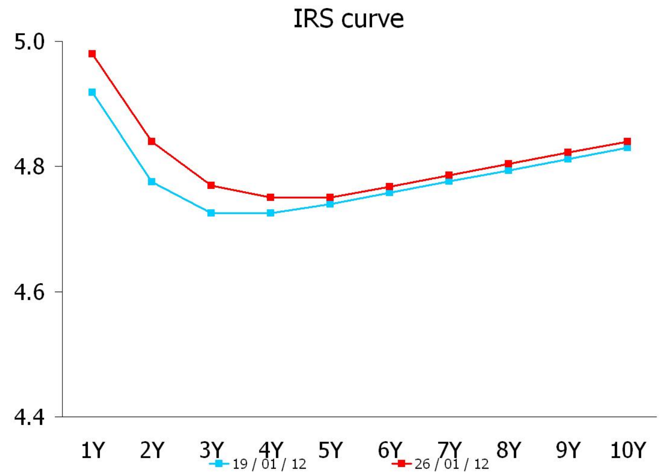
GDP decomposition support our view on the mechanisms driving the growth in the Polish economy. Private consumption in 2011 increased by 3.1% y/y. At the same time Q4 2011 consumption growth could have increased by less than 2% against 3% in Q3 2011. It means that households have already accelerated the adjustment to price and exchange rate shocks (in around Q3 we estimated that the total impact stemming from those is likely to shave off around 1.4pp from annual consumption growth). On the other hand, fixed business investment surprised positively by growing 8.7% in 2011. It means that during Q4 2011 the increase could have reached more than 10% against 8.5% in Q3 2011. These data proves that the process of rebuilding lost production capacity (by obseolescence or physical wear and tear) is continuing. What is more, positive contribution of public investments to GDP growth was probably maintained. Additionally, in Q4 2011 stabilizing factor of exchange rate lead net exports contribution to around 1.5pp.

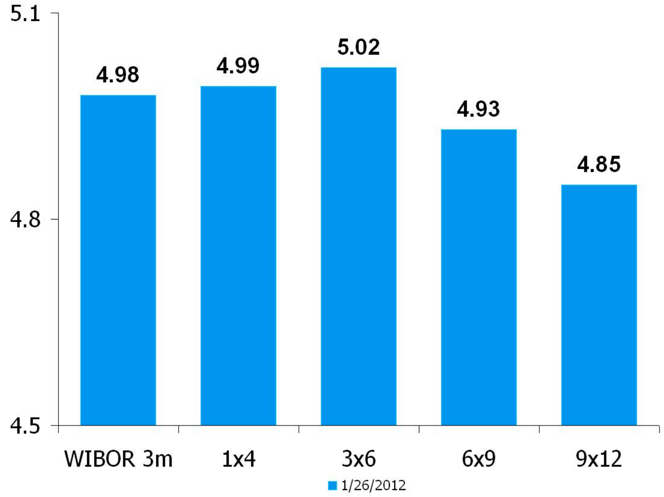
Data indicate progress in re-balancing of the Polish economy (lower consumption and net exports increase) and improvements in production capacities (high investment). Due to relationship between enterprises' investment activity and employment these data can be perceived as a moderation of risk connected with labor market (it is not a surprise for us, since we repeatedly state that the deceleration in labor market progresses a way slower than in 2008/2009).

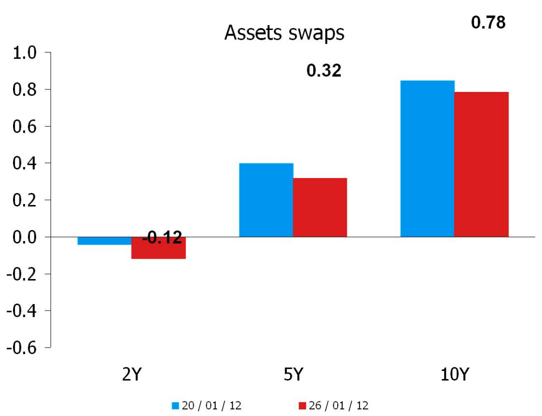
Fixed income

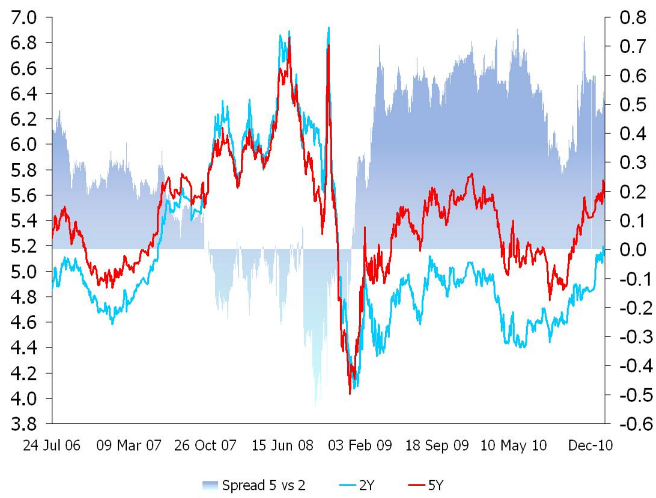
Risk off...risk on?

Hawkish statements from MPC members, that we have heard quite a lot recently have so far no real impact on the rates. This week however, similar comment from the NBP governor couldn't have been ignored. As Mr. Belka doesn't see chances to consider policy easing this year and, moreover, he thinks discussion about rate hikes could be justified that must have been finally reflected in rates levels. 1Y and 2Y moved up by some 7-8bp, 6x9 and 9x12 FRAs by as much as 15bp and curve flattened even further. We think most improtant question here is whether they actually would hike rates and if they did, would that really be a good move and what would that mean for the curve. Surprisingly enough, MPC that has always been relatively dovish is changing into (extremely) hawkish now, when the economy is quite close to the turning point and next steps would rather be policy easing (maybe in a year perspective, but still). Missing an opportunity to deliver a preemptive hike in autumn 2010 led to four almost consecutive moves beginning of next year, as inflation situation turned to be not as under control as previously expected. As for the past half of a year the MPC was in the wait-and -see mode and was expecting that tightening already done would allow CPI to move back to target in the near future, now it seems they might have realised, that this 100bp wasn't enough and further action is required. To us it is quite different. Now it is the time, when we're likely to see economy rebalancing and inflation actually slowing, all is needed now is simply a little more patience. Currency has already strengthened enough from weakest levels to reduce CPI by some 0.6% y/y and that is likely to continue - hawkishness would be sufficient without any actual actions. Wibor rates over past few months went up by some 25bp, which is technically a hike. 9x12 FRA trades just 10bp below 3m Wibor (which as I mentioned is already elevated), so all easing hopes for the year have vanished. 1Y1Y forward at 4.70 only prices in a normalization of money market rates, not actual rate cuts. As we said last week, we prefer 5 and 10y sector of the curve and bonds over rates. Yes they gained 25bp already this year and probably correction is due, but that wouldn't be neither long-lasting, nor deep and be an opportunity to add to longs. If someone really wants to hedge/speculate on rate hike this year, very front end of the curve is the sector to place such bets. 2Y is way too long. Naturally 1y1y can move up by 20bp but it will finally drop 100bp, so in case 2y pushes further, it will be receive as well.







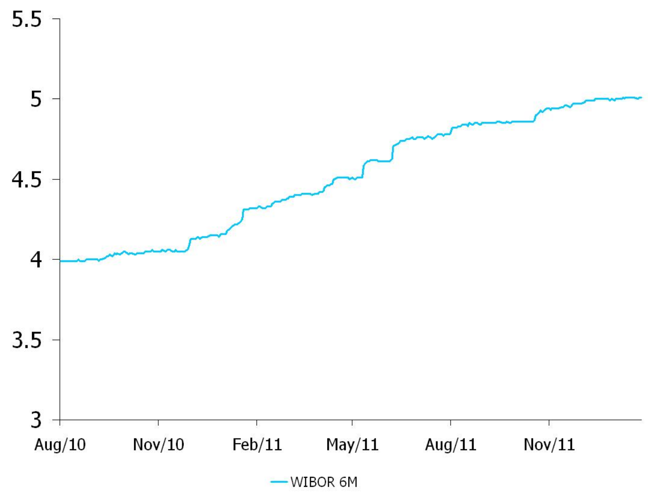


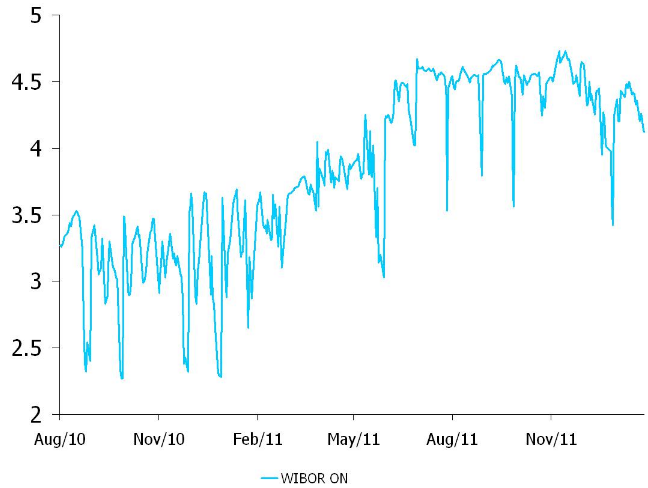
Money market

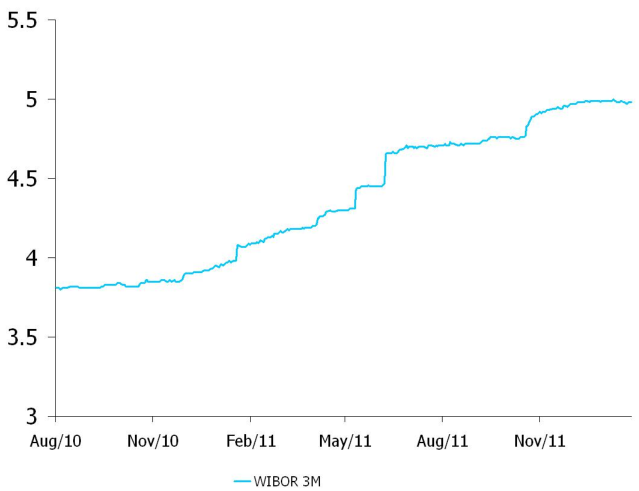
Hawkish MPC, hawkish Mr Belka

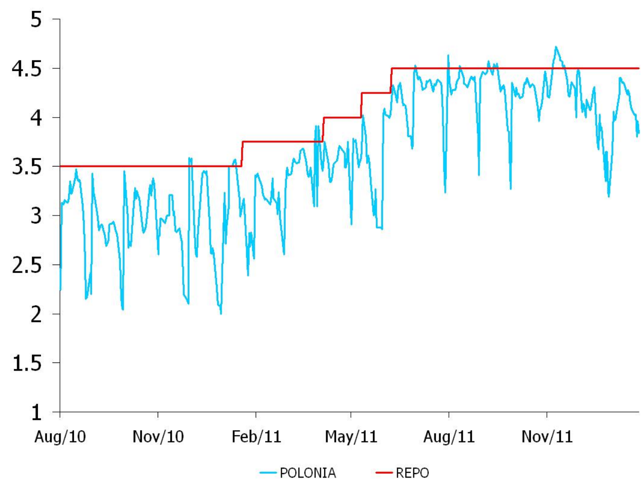
Free falling as far as the cost of carry is concerned. Despite the extra OMO surplus was only growing, pushing the shortest rates towards 3%. We even saw the deposit in the central bank exceeding 1 bln pln. In our opinion last day of the reserve will be very cheap, despite another 1 day OMO. Looking back in January, the relatively low cost of carry plus extremely cheap December may indicate any structural liquidity changes in the system. Having all the OMO substantially underbid, constantly growing surplus and falling rates, the question occurs: why the central bank is unable to sterilise the market and why the market is not buying the bills when it becomes really competitive to deposits. We think it is worth having closer look in February to sustain or reject the theory about possible change of the liquidity layout.

More MPC member’s voices in the air and all of them bearish. The market was ignoring them until Mr Belka himself gave quite a bearish speech. No doubt no fast rates cut expected. This sentiment has probably disappeared for a while. A hike is also not our base scenario but we see the probability of this event highly underpriced in the curve. Worth observing next week are CPI expectations and PMI index. Both may support hawks.





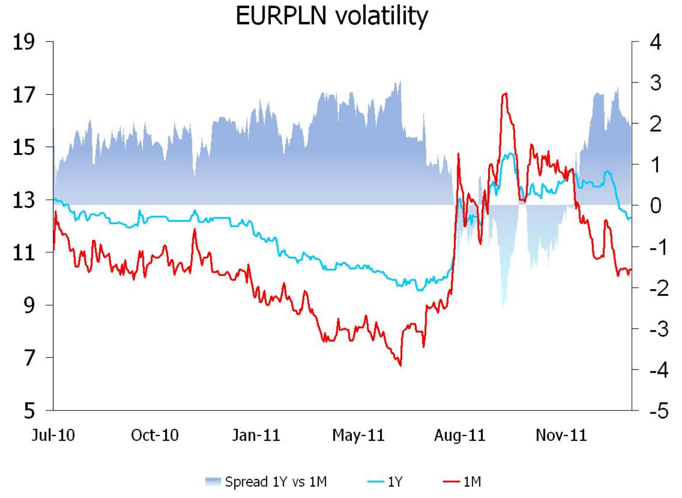




Forex

Zloty close 200 DMA 4.2150 The risk is ON. The more hawkish the main policy makers are, the bigger the appetite to buy PLN. The Head of Polish CB Belka also has contributed to the trend because of his hawkish comments. The year low in EUR/PLN is so far 4.2120 (with a little help of the buy PLN order out from Nederland's), and we can not help the feeling we have gone too quick too far.

Vols lower The frontend of the volatility curve for EUR/PLN is holding relatively well due to the fact that the short term gamma is more less performing plus the market being short gamma around 4.20 (seemed so far away not a long time ago). The selling pressure is still in the back end of the curve the 6month were given 11.55%, the mid 1y is now 11.9 versus last week 12.25%. the risk reversal are 0.2 lower in the currency spread (difference between USD/PLN and EUR/PLN) consolidated around 7.75%.

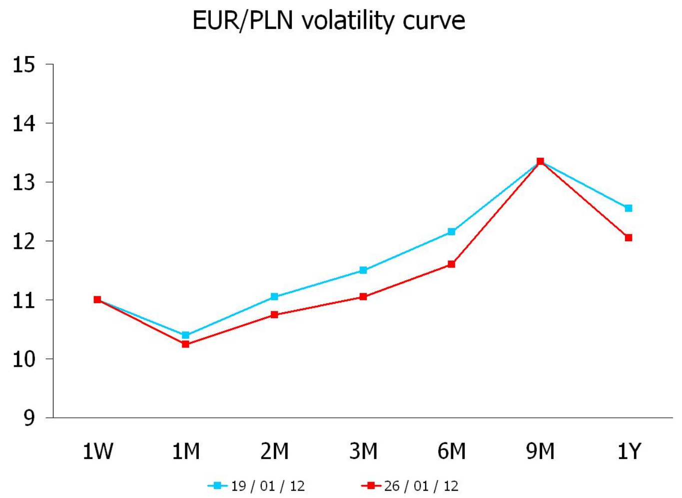


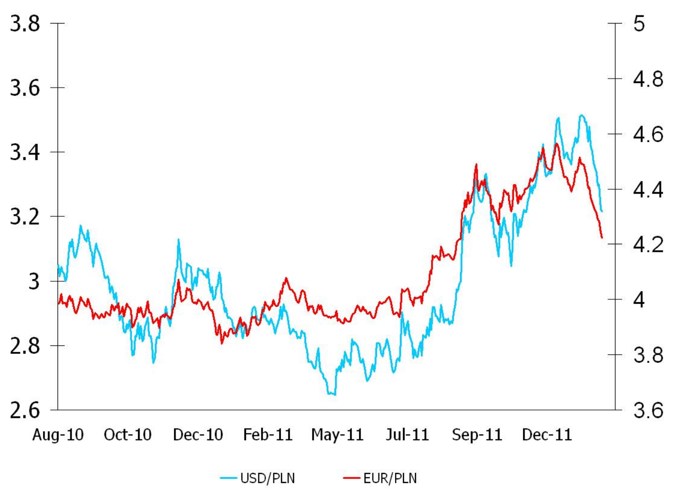
Short-term forecasts.

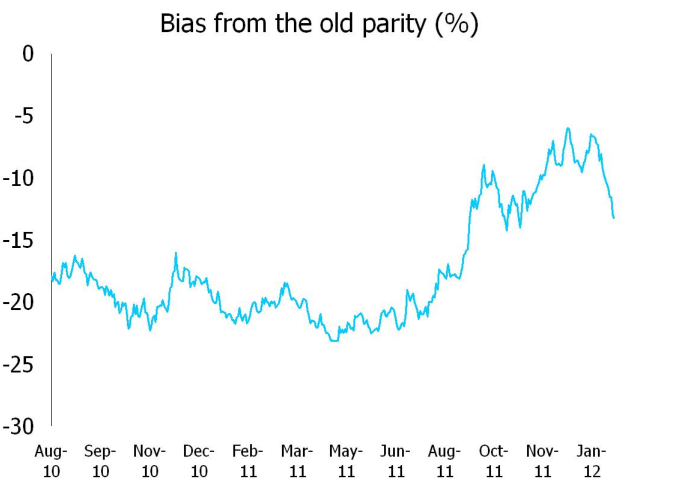
Main supports and resisances
EUR/PLN: 4.2000 / 4.3500
USD/PLN: 3.1500 / 3.3500

Spot. We think the 4.2150 200 DMA should provide at least short term support. We will try small long EURPLN 4.2150 with a stop loss at 4.1800 and proft taking 4.3200.

Derivatives The picture is blurred. The implied volatility is still well above its historic ones. Same with skew... but the ATM's are much lower then the beginning of the year and the Risk reversals also, so we are not chasing that move and instead we are waiting sidelined for same further developments...







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
1/20/2012	4.73	4.98	4.80	6.49	4.98	6.59	4.96	4.94	4.80	4.69	4.53	4.80
1/23/2012	4.79	4.97	4.64	4.90	4.66	4.90	4.95	4.96	4.79	4.68	4.58	4.81
1/24/2012	4.63	4.98	4.65	4.91	5.01	4.91	4.98	4.96	4.81	4.71	4.61	4.83
1/25/2012	4.75	4.98	4.79	4.91	4.79	4.91	4.99	5.00	4.93	4.85	4.70	4.95
1/26/2012	4.65	4.98	4.66	4.91	4.67	4.91	4.99	5.02	4.93	4.85	4.65	4.95

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
1/20/2012	6.590	4.605	4.750	4.707	4.720	5.118	4.820
1/23/2012	4.900	4.493	4.760	4.656	4.740	5.069	4.840
1/24/2012	4.910	4.516	4.775	4.686	4.770	5.126	4.870
1/25/2012	4.910	4.565	4.800	4.698	4.810	5.145	4.930
1/26/2012	4.910	4.544	4.840	4.723	4.750	5.067	4.840

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY	
Date	1M	3M	6M	1Y	1M	1Y	1M	1Y
1/20/2012	10.35	11.25	12.05	12.35	12.35	3.40	0.39	0.74
1/23/2012	10.15	10.90	11.60	12.25	12.25	3.40	0.39	0.74
1/24/2012	10.35	11.35	11.95	12.30	12.30	3.40	0.39	0.69
1/25/2012	10.35	11.35	11.95	12.30	12.30	3.40	0.39	0.74
1/26/2012	10.25	11.05	11.60	12.05	12.05	3.40	0.39	0.94

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/20/2012	4.3260	3.3537	3.5819	4.3442	1.4181	0.1705
1/23/2012	4.3111	3.3353	3.5707	4.3310	1.4200	0.1694
1/24/2012	4.2885	3.2970	3.5545	4.2640	1.4234	0.1692
1/25/2012	4.2855	3.2990	3.5453	4.2234	1.4352	0.1693
1/26/2012	4.2431	3.2233	3.5147	4.1607	1.4427	0.1687

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