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POLISH WEEKLY REVIEW

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Comment on the upcoming data and forecasts

GDP slowdown in Q1 can be quite meaningful (3.4% vs 4.4% in Q4 2011 - publication on Thursday). We see a possibility of a minor bounce in consumption (better retail sales, slightly better VAT revenues), but we also remind that all episodes of consumption slowdowns after 2004 were strictly monotonic. Investment should have grown by around 10% (almost the same rate as in Q4 2011) as weaker public spending was offset by private investment cycle (mostly replacement investment). With most important GDP categories almost unchanged, the reason for the slowdown lies mainly in net exports which is likely to add only a bit to GDP growth (0-0.1pp.). Contribution from trade balance should increase in coming quarters as soon as slowdown becomes more entrenched. However, this is a rebalancing (statistical) item in the Polish accounts and as such implies that at the same time internal demand will be lagging behind, with further consumption deceleration (towards possibly 1%) and investment slowdown already put on the table. Overall we expect 2.8% GDP growth in 2012 with more or less monotonic slide to 2% in Q4 2012.

Polish data to watch: May 28 to June 1

Publication	Date	Period	BRE	Consensus	Prior
GDP y/y (%)	31.05.	Q1'12	3.4	3.4	4.3
Inflation expectations (%)	31.05.	May		4.2	4.3
PMI (pts)	1.06.	May			49.2

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 OK0114	6/20/2012	7500	4.759	4/19/2012
5Y T-bond PS1016	6/20/2012	4200	5.047	5/18/2012
10Y T-bond DS1021	7/11/2012	4000	5.349	5/10/2012
20Y T-bond WS0429	7/11/2012	4000		5/10/2012

Macroeconomic forecasts

Wskaźnik	2008	2009	2010	2011	2012 F
GDP y/y (%)	5.1	1.6	3.9	4.3	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	12.5	13.6
Repo rate (end of period %)	5.0	3.5	3.5	4.5	4.75

	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2 F
GDP y/y (%)	4.5	4.3	4.2	4.3	3.4 (F)	2.8
CPI Inflation y/y (average %)	3.7	4.2	4.1	4.6	3.9	4.2
Repo rate (end of period %)	4.0	4.5	4.5	4.5	4.5	4.75

F - forecast

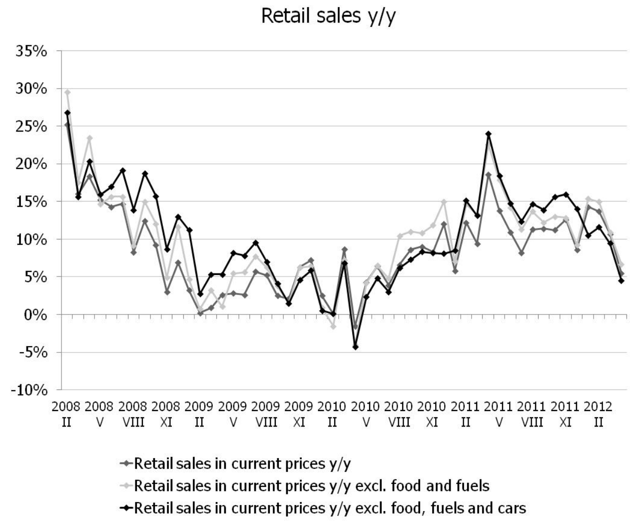
Economics

Industrial output rebounds slightly

1. **Output.** Industrial output accelerated in April to 2.9% y/y from 0.7% in March. Composition seems neutral with both growth champions and laggards spread almost randomly between export-oriented sections and mostly domestic ones. However, we think that over time it will be domestic sections dampened by lower growth of consumption and infrastructure investment that will be decisive for Polish growth. External factors flowing from the performance of the German economy and seemingly positive effects of zloty depreciation have potential to smooth the cycle but not to revert it. We stick to the scenario that Polish economy is poised to a slowdown, possibly monotonic one with a target close to 2% in the year end (whole year growth 2.8%). However, it will not be a repeat of 2009.
2. **Producer prices.** Growth of prices in industry slowed a bit to 4.3% from 4.4% in April. The slowdown would be more pronounced if gas prices had not been lifted higher - we think that this effect alone can explain 75% of 0.6% m/m growth of total output prices. Owing to the trends in commodities (somehow offset by zloty depreciation), it is possible that growth of industrial prices will be off 4% mark in May.

Significant drop in retail sales

Retail sales posted an increase of 5.5% y/y in April (significantly below market expectations for 9.4% and our much lower forecast 8.0%), decelerating sharply from 10.7% y/y measured a month earlier. Slowdown results mainly from a steep deceleration of food sales (only 1.0% y/y after 9.8% in March), which suggests significant impact of much earlier Easter in 2012 (which caused shopping shift from April to March while April high base effect from 2011 remained in force). Similar base effects are visible in non-specialized stores (8.5% y/y after 17.7% in March) and wearing apparel (1.4% after 14.4%). Core retail sales (excluding food, fuels and cars) also decreased significantly (see chart) and what should be mostly highlighted, the annual growth rate of retail sales in constant prices moved toward 0% (in core terms went below 0% mark). April data are consistent with deteriorating trend in wholesale trade, slowdown on the labor market and stabilization of households' expected financial situation on historically low levels (which exhibit high leading properties, therefore we still have some way to go down from current consumption levels). All these fit perfectly into our base scenario of gradually slowing sales and consumption - we expect further weakness in the retail trend, only to be interrupted temporarily by the EURO2012.



What will be MPC's next move?

Although industrial data was not followed by market reaction, significantly lower retail sales was able to move short FRA rates about 4bp down. It seems reasonable as MPC is always highly focused on retail sales figures (while we still stress that its statistical quality is weak). After all publications from the real sphere released after May hike, MPC seems to still stick to its optimistic outlook (based mainly on NBP's business tendency indicators - as stated in lately published „Minutes"), so it is still elevated inflation (and inflation expectations) remaining a key factor for further decisions. According to previous communication, MPC has already decided not to change the parameters of monetary policy in June and only July decision remains a question. July seems to be the last possible moment for hike, since the realization of our macro scenario (slowdown stronger than MPC and the market anticipate, risks for investment and consumption) will not allow the Council to maintain hawkish rhetoric in September (there is no decision meeting in August). From today's perspective the poor retail sales release could have caused some second thoughts for the MPC (an "against" factor), but the key factor for the decision is still inflation projection (to be published in July - rather a "for" factor) and more and more expected loosening of monetary policy by the ECB (which may be announced in June, especially taking into account the PMI indices' drop in the euro area - another "against" factor). To sum up, after April's data the least that can be said is that the likelihood of the next hike has not increased.

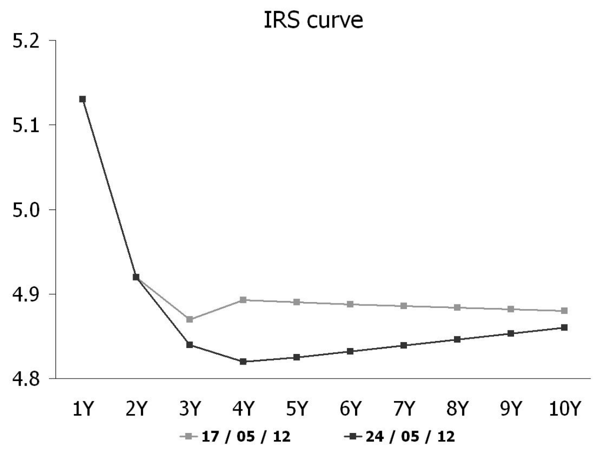
Fixed income

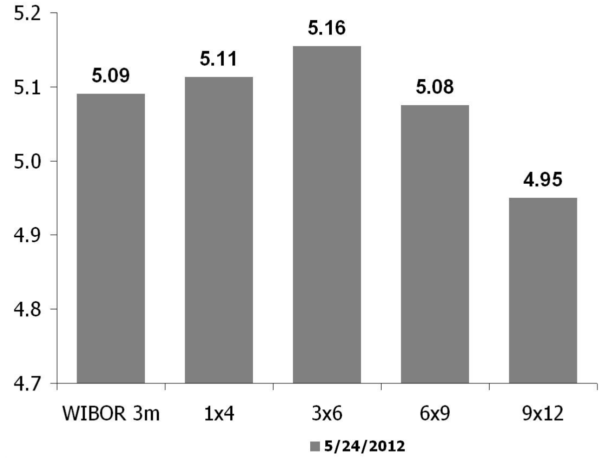
Greek rollercoaster

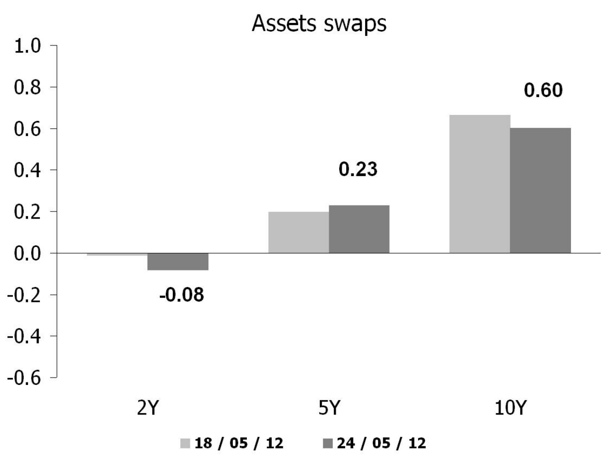
As the "Greek drama" prevailed, the market seemed to continue the risk-off trades globally. Surprisingly the PLN market turned out to be quite stable considering the Europe's financial turmoil. Both the swap curve and treasury bonds were trading in a narrow 5-7bp range, depending on the current global mood. The credit risk covering trades from the last week that resulted in widening of asset swaps have temporarily ended paving the way for cash funds to reenter the bond positions again at local lows. The most awkward trading had been spotted at the front end of a yield curve, anyway. Regardless of the last rate hike the still existing threat of the next tightening and constant upside pressure on cash deposits, the market started to sell FRA contracts maturing this year below the current Wibor rate.

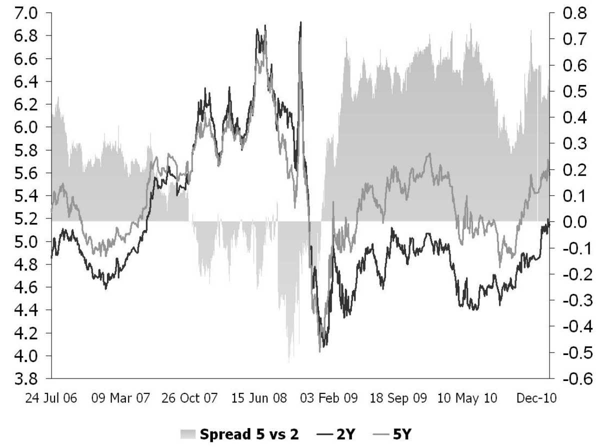
Just to analyze this phenomenon we started to assess the possibility of a rate cut in Poland this year. Regarding the latest comments from both ECB and MPC members, the probability of such scenario seemed to be so low that could be neglected. The ECB's Lipstock said on Wednesday the central bank had no single discussion about cutting main rate in euroland below 1% and it saw no need for additional ECB stimulus at that moment. Simultaneously, the MPC's Hausner stressed on Thursday the Council might be forced to rise interest rate once again if the CPI projection showed the higher path with a lesser than expected downturn in the mid-term. He also added the Polish central bank could not ignore the latest zloty weakening and it did not wish to tolerate the real interest rates at zero for a long time. As the domestic economy was expected not to undergo a severe economic slowdown, the Polish central bank should follow the conventional, not „crisis one" monetary policy for now.

As a result we maintain our previous hints about the current risks in a short-term. We still expect the MPC to leave the main rate unchanged in June but we believe it might announce the possible rate hike in July on a new higher CPI path projection as a new evidence fair enough for another tightening. Considering the constant upside pressure in the cash market we would see a great value to pay short term rates below Wibor till cancelled.









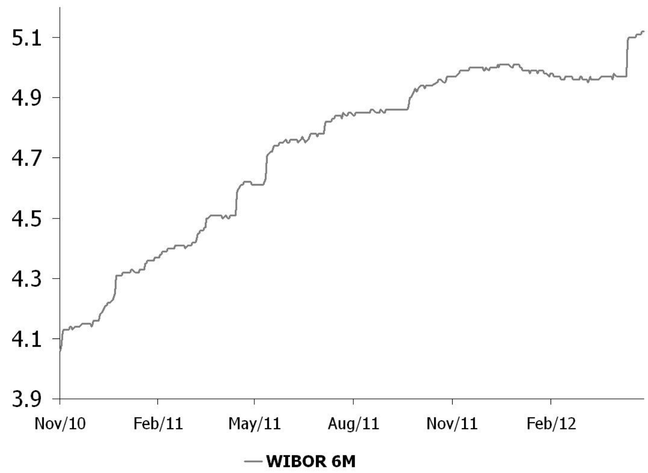
Money market

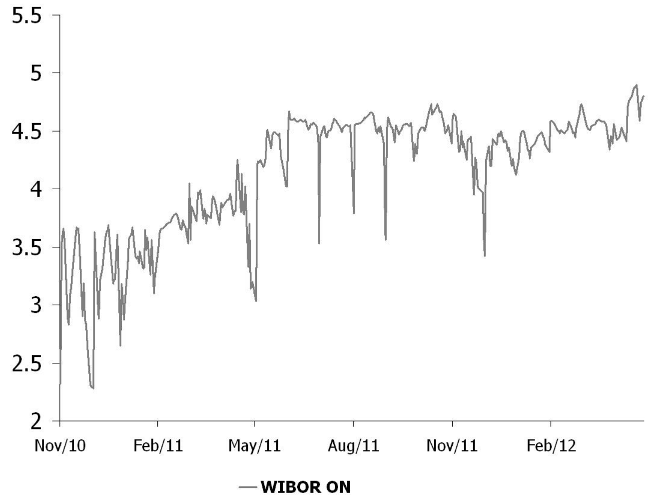
Shortest rates to drop next week. Front end still attractive for our view.

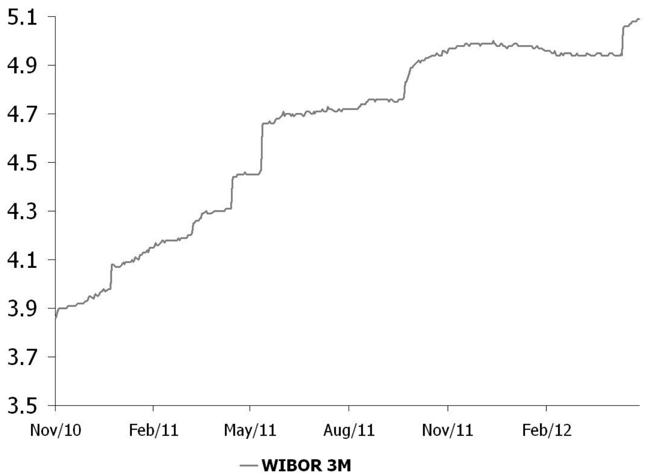
Shortest rates should drop at the beginning of next week, since today's OMO lefts the market with the cash surplus of around 2 billion pln. The end of the reserve is on Wednesday, therefore we do not expect an additional auction on Tuesday (there will be one on Wednesday but only for 1-day bills). All in all, we ought to face a cheap end of the reserve, and start a new one with a balanced account.

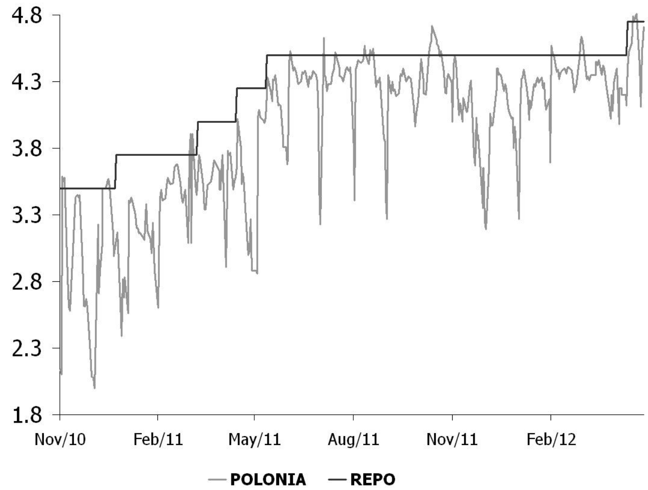
IO and PPI figures were ignored by the market that was mainly driven by external factors (Greece of course). Today we had much poorer then expected retail sales figure (5.5% vs 9.4% expected) and the front end lost a few bps. We still think that the rate hike may occur in July and that the CPI projection will be a crucial decision making factor. Therefore, we use dips to pay the front end and we will definitely keep them until the MPC conference after June's meeting (if the MPC wants to keep the standard from the last movements the hike may be preannounced to the market in June).

Stay pay.





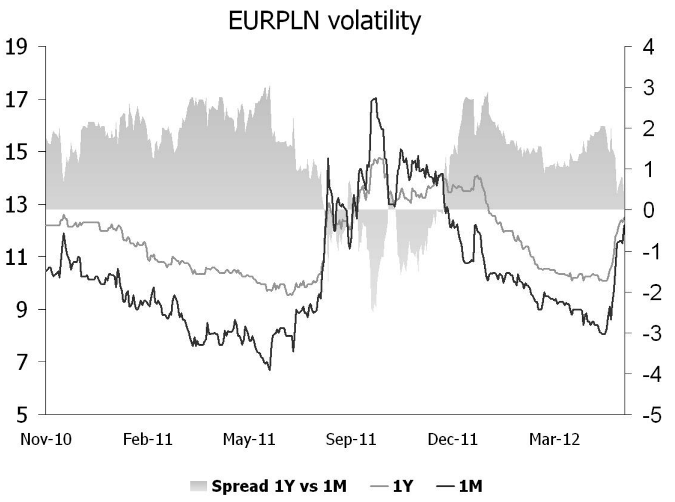




Forex

Consolidation in 4.30-4.40 range The correlation of XXX/PLN crosses and EUR/USD is back in style! The PLN is virtually mimicking the EUR/USD moves. The downside correction, from the fresh EUR/PLN 4.4015 high, was stopped at 4.3050, well above the strong technical 4.2850/4.2950 support zone. Till then we are consolidating in wide 4.3000-4.4000 range. With EUR/USD in the driving seat we may assume that if EUR/USD will plunge bellow 1.2450 we will see the EUR/PLN above 4.4000...

Consolidation The correlation with EUR/USD extends to vol trading as well. Despite the temporary relief rally in PLN the EUR/PLN vols haven't retraced much of their is gains, we still have the 1month mid at 12.00% mid and 1 year at 12.4% mid with sympathy to strong EURU/USD curve. The currency spread (difference between EUR/PLN and USD/PLN vol) is rising because of that, reaching 7.75% (6.25 2 weeks ago). The skew in USD/PLN is also bid as RR on EUR put also rises in value.

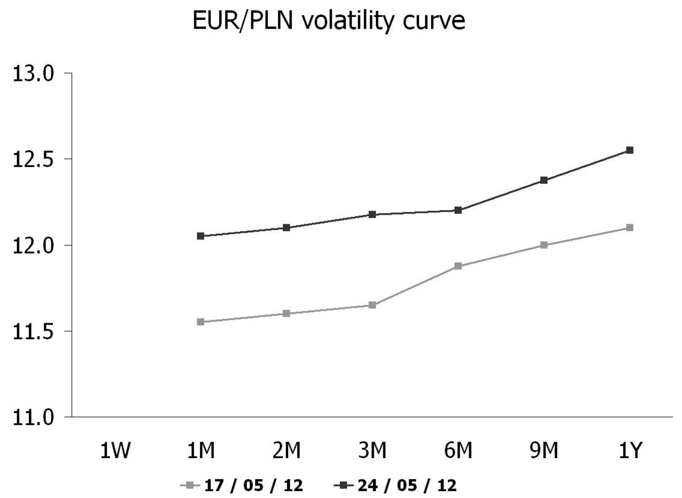


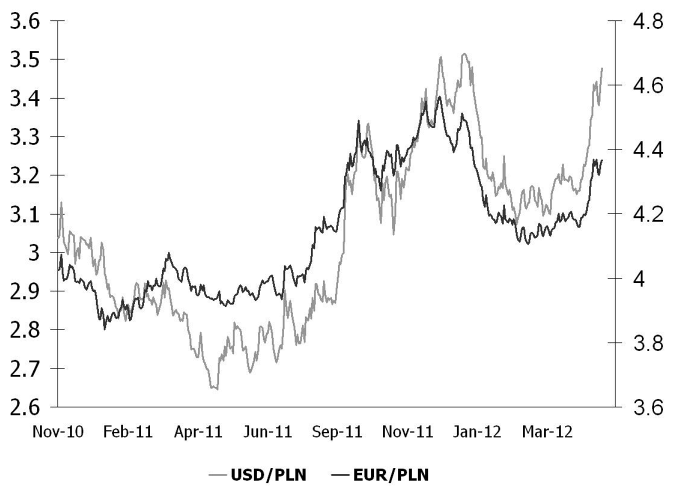
Short-term forecasts.

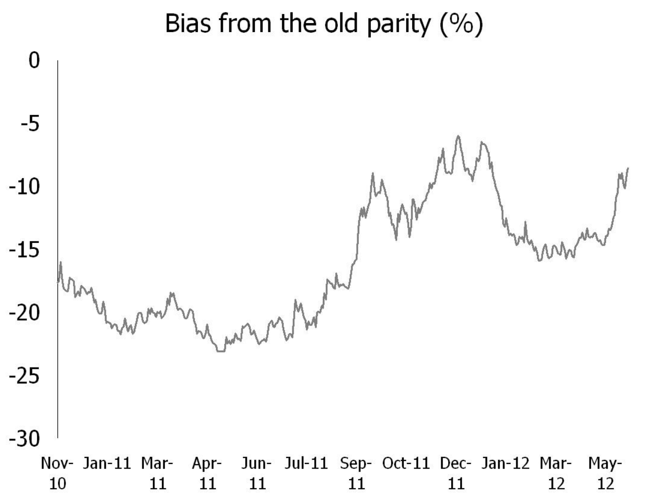
Main supports and resisances
EUR/PLN: 4.3000 / 4.4000
USD/PLN: 3.3000 / 3.5000

Spot. The risk on /risk off game is in full effect. We will try to play the current range 4.30/4.40 on EUR/PLN. The global risks are bringing us to conclusion, that its more likely that it will be rather 4.40 band first on the line of fire...

Derivatives The main vols curves (EUR/PLN and USD/PLN) are holding firmly the freshly gained ground. The biggest risk we see to the higher levels, as the supply is virtually nonexistent. The break of 4.40/4.43 resistance zone would be the fresh catalyst for XXX/PLN vols to shoot higher. Probably targeting last years highs roughly 15% on 1 month and 14% for 1 year.







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
5/18/2012	4.72	5.08	4.85	6.49	4.90	6.59	5.09	5.12	5.08	4.94	4.76	5.06
5/21/2012	4.85	5.08	4.88	5.01	4.88	5.01	5.10	5.10	5.06	4.93	4.72	5.06
5/22/2012	4.85	5.08	4.98	5.01	5.03	5.02	5.11	5.12	5.05	4.95	4.72	5.06
5/23/2012	4.83	5.09	4.98	5.02	5.03	5.02	5.12	5.15	5.08	4.96	4.77	5.10
5/24/2012	4.88	5.09	4.91	5.02	4.92	5.03	5.11	5.16	5.08	4.95	4.72	5.07

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
5/18/2012	6.590	4.813	4.870	4.858	4.815	5.013	4.810	5.473
5/21/2012	5.010	4.813	4.850	4.846	4.755	4.975	4.780	5.427
5/22/2012	5.020	4.813	4.880	4.827	4.810	5.034	4.850	5.428
5/23/2012	5.020	4.813	4.915	4.856	4.835	5.090	4.870	5.500
5/24/2012	5.030	4.813	4.920	4.839	4.825	5.054	4.860	5.462

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
5/18/2012	11.60	11.80	12.00	12.30	12.30	4.00	0.64
5/21/2012	11.60	11.80	12.10	12.40	12.40	4.00	0.64
5/22/2012	11.50	11.65	12.00	12.30	12.30	4.00	0.64
5/23/2012	12.20	12.15	12.30	12.50	12.50	4.08	0.64
5/24/2012	12.05	12.18	12.20	12.55	12.55	4.08	0.64

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
5/18/2012	4.3683	3.4431	3.6371	4.3407	1.4614	0.1717
5/21/2012	4.3322	3.3928	3.6070	4.2718	1.4568	0.1718
5/22/2012	4.3205	3.3811	3.5973	4.2470	1.4567	0.1717
5/23/2012	4.3576	3.4460	3.6285	4.3379	1.4428	0.1715
5/24/2012	4.3665	3.4779	3.6357	4.3794	1.4515	0.1716

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