BRE BANK SA

POLISH WEEKLY REVIEW

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Table of contents

Comment on the upcoming data and forecasts

On Monday last data for May will be published. We expect retail sales to slightly increase the pace of annual growth compared to April mainly due to lower base from 2011 and reversed effect of food category compared to the previous month (its contribution rises to about 2pp). Although variety of economic indicators still point to lower consumption there is unclear effect of EURO2012 in May and June (industrial production positive surprise mainly on food category poses upward risk, while rumors from media indicate lower demand in shopping centers). Published simultaneously unemployment rate will decrease by 0.3pp. to 12.6%, but seasonal drop is historically small and confirms weakening of labor market.

Polish data to watch: June 25th to June 29th

Publication	Date	Period	BRE	Consensus	Prior
Unemployment rate (%)	25.06.	May	12.6	12.6	12.9
Retail sales y/y (%)	25.06.	May	6.0	7.3	5.5

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	7/19/2012	7500	4.759	4/19/2012
5Y T-bond PS0417	7/19/2012	4800	4.784	6/20/2012
10Y T-bond DS1021	7/11/2012	4000	5.349	5/10/2012
20Y T-bond WS0429	7/11/2012	4000	5.563	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 (%)	4.6	4.2	4.2	4.3	3.5	2.8
CPI Inflation y/y (average %)	3.7	4.2	4.1	4.6	3.9	4.2
Repo rate (end of period %)	4.00	4.50	4.50	4.50	4.50	4.75

F - forecast

Economics

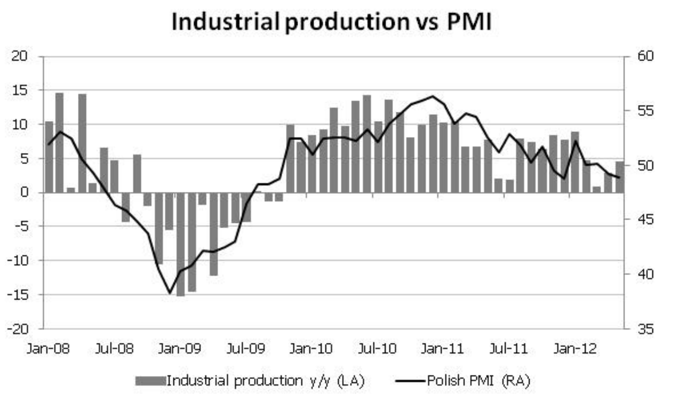
Wages growth a bit higher. Employment falling slowly on monthly basis.

Wages. Growth rate of wages accelerated in May to 3.8% y/y from 3.4% in the prior month. However, acceleration stems mainly from the base effect from the last year whereas trend growth in most business activity sensitive manufacturing has been slowly falling in recent months. We expect lower growth of wages in the coming months (and even quarters) as enterprises do not plan significant increases and the bargaining power of employees seems to be on the decline along with slowly softening labor market. This trend is set to lower consumption growth in this year and possibly also in the next (we do not expect any rebound in 2013).

Employment. Payroll employment growth remained steady at 0.3% y/y in May. On monthly basis enterprises shed ca. 1k of workers. The numbers suggest that softening of the labor market continues, albeit temporarily at a slower pace. May and June may be temporarily distorted by one-off gains in restaurant and hotels which are connected with EURO2012 tournament. However, the trend in employment is still downward sloping with (something more than a) tail risk of 100k job destruction connected with infrastructure investment.

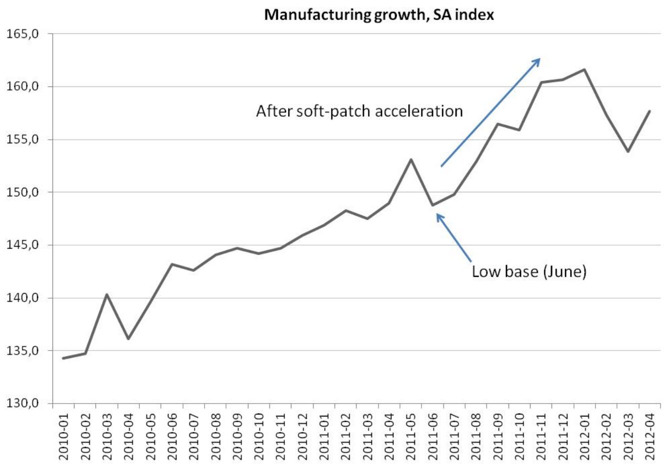
Industrial output surprises on the upside, producer prices up

Industrial output surprised to the upside growing by 4.6% in May (market consensus 2.5%, previous 2.9%). We cannot point one single factor responsible for the surprise; such a development may be connected with EURO2012 and this hypothesis is corroborated by a sharp acceleration in food processing (a shot from nearly 3% growth in April to more than 12% in May and this aggregate is a heavy-weight of around 20-21% of the whole manufacturing). Reading decomposition is not unequivocal, however it indicates that export sectors such as manufacture of furniture and motor vehicles do not perform well (-10.3% y/y and -7.2% y/y respectively) despite support from the weaker zloty.



Producer prices accelerated to 5.0% y/y from 4.3% in the prior month. The reading confirms the notion that local prices are closely tied to EURPLN rate even in times of a slowdown in economic activity. Owing to the tendencies in EURPLN rate in June and the distribution of base effects, next month's reading may be close to 4.8-4.9%.

Perspectives in industrial sector for the following months are as follows. Next month is subject to upside risk due to low statistical base effects and also from that reason after June we can expect visibly lower growth of industrial output. The more so since the seasonally adjusted path of manufacturing was unusually steep since August 2011 and this was connected with a rebound from a soft patch from 2011.



Much softer June „Minutes"

In „Minutes" from the June meeting the Council noticed deteriorating sentiment and rising risk aversion in the international financial markets. GDP data in Q1'2012 confirmed also the gradual weakening in the Polish economic activity (some Council members expect even slower GDP growth in Q2'2012, with what we agree). Nevertheless, the discussion on outlook for growth in the subsequent quarters clearly divides MPC into relatively small groups (there is no single argument supported by „majority" or even „some members"). There is greater consensus in labor market assessment - not only unemployment rate is growing, but also employment level decreases and in this context some Council members see no intensification in wage pressures and only limited risk of second round effects (this is significantly softer rhetoric than the one presented in the previous „Minutes").

MPC assessment of inflation remains unchanged as it points (some members) that inflation is set to be above the target for a prolonged period. However, the reasoning staying behind this line of thinking has changed - now it is high core inflation which is the culprit. The change of rhetoric has come rather in cumbersome moment. Recent drop of core CPI to 2.3% (after unexpected growth in April to 2.7%) should be a painkiller for the members focused on stripped inflation measures.

In terms of interest rates the rhetoric has changed significantly. Some MPC members assessed that „the current level of interest rates might be adequate to maintain price stability over the medium term". What is interesting few Council members suggest that any further interest rates increases may force additional fiscal adjustment and result in curbing of economic growth. Therefore „some Council members emphasized that amidst the on-going slowdown, the increase of NBP rates at the previous meeting was probably a sufficient adjustment to the current and anticipated macroeconomic developments". Although majority waits for new NBP inflation projection (to be published in July), the revealed sensitivity of MPC to upcoming data limits the risk of making a difficult decision mainly on forecasts (especially in highly volatile macro environment).

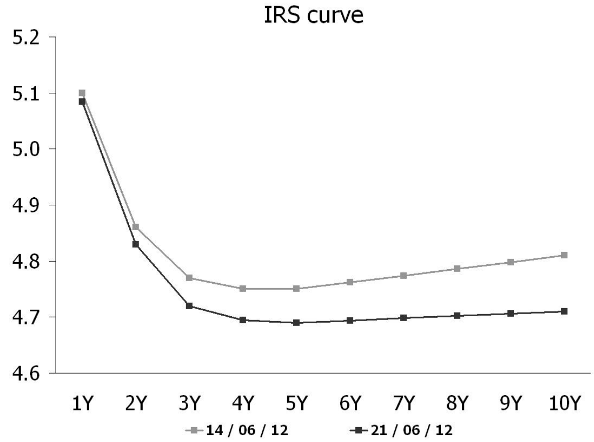
Monetary policy perspectives

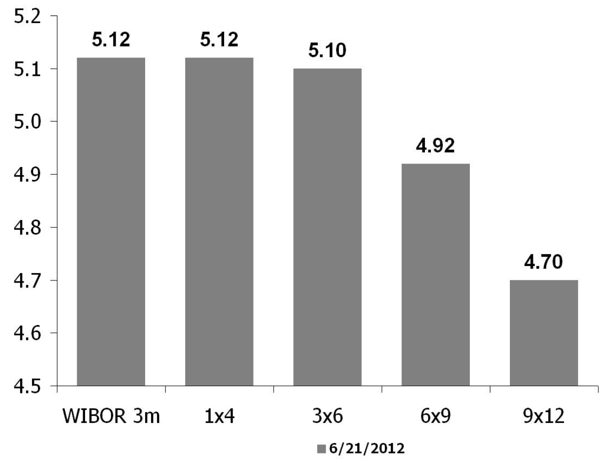
Employment and wages were recognized by the market as another downside surprise after lower CPI reading and relatively dovish comments by NBP's governor Belka, who said that May inflation „was a positive surprise". Better industrial output reading is not unequivocal as it can be severely distorted by EURO 2012, export sections are under-water and the more domestic-oriented ones are likely to follow owing to the snapping (downward) trends in consumption and investment. What is more, looming easing from major central banks is likely to support the zloty, which may be another disinflationary factor near term. As July's interest rate hike was not announced at all, Belka and other members (Zielińska-Głębocka, Chojna-Duch, Kaźmierczak) stay relatively soft, we stick to our base scenario of no change in rates level in July. MPC is also unlikely to act solely on inflation projection and pre-commit to any rate changes at the next, September meeting. We expect the GDP slowdown to become more pronounced and prospects for inflation to brighten till then. It speaks for a scenario in which May's rate hike was the first and the last this year. However, although market attention moves more towards rate cuts (FRA rates price 2 cuts in 9 months, 1 cut in 6 months and risk of cut in 3 months) especially after positive inflation surprise and dovish Chojna-Duch statements, we think such a scenario is still distant due to stability issues and pre-condition that Poland needs overall higher interest rates to attract foreign capital and stimulate savings. The MPC may consider rate cuts no sooner than when real interest rates rise i. e. when inflation substantially fall. And this is not going to happen before the turn of 2012/2013.

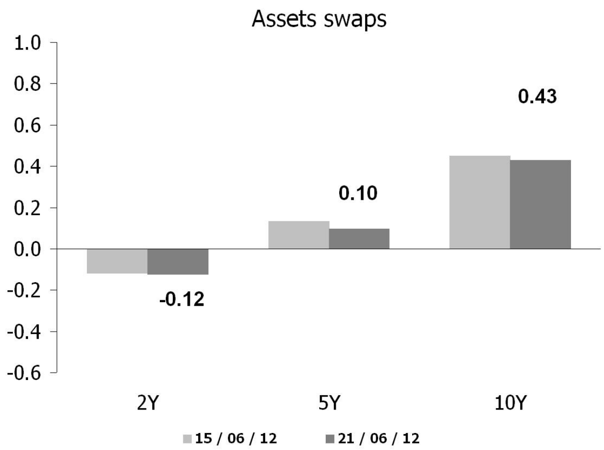
Fixed income

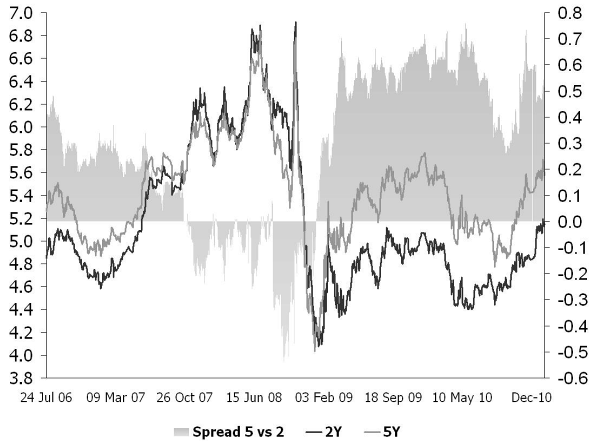
The change and the preparation

Last week was very interesting on the FI market. Bonds and rates managed to break out higher in prices from the the old range. PS1016 traded above 100.00 level, 10y bonds started to underperform a little after very handsome 2.5% rally. Rates also moved lower, 2y5y and 2y10y steepened a little bit. Economic releases were mixed, confirming slowdown in the economy, but at a moderate pace. The highlight of the week was interview with Chojna-Duch (dovish MPC member) who indicated possibility of a rate cut in not a distant future. Kazmierczak (MPC member) said that CPI is high, but also mentioned rate cut possibility, should real rates start to grow. We are entering right now a summer period, which in our opinion will be characterized by the two phenomena. 1) There will be a set of mixed data, confirming slow down at a moderate pace, and also rather elevated CPI. 2) Lack of supply of bonds in the primary market, as MinFin has already secured 80% of borrowing need and there is big maturity of OK0712 in July. We think that rates have picked, and now is the time to put on positions which will be reaction to 1) a change in RPP rhetoric, 2) will benefit from low supply in bonds. Autumn will bring clearer picture of the more profound slowdown as well as much lower CPI rates. Our favorite call is bonds that have 5y maturity or shorter, also we like paying FRA spreads 9x12 ag red FRAs . Also 2y5y steepener should perform well.







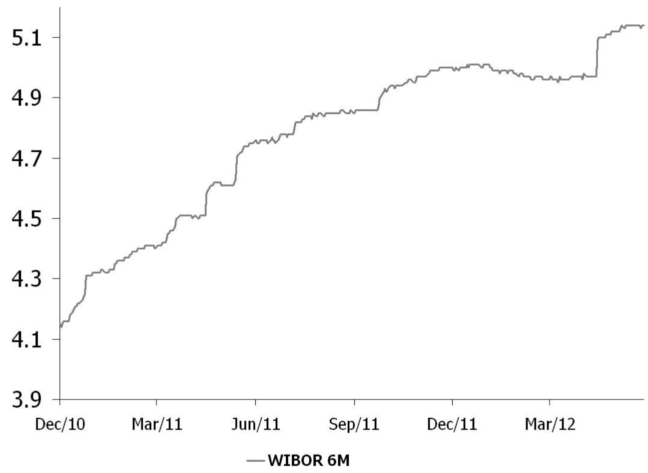


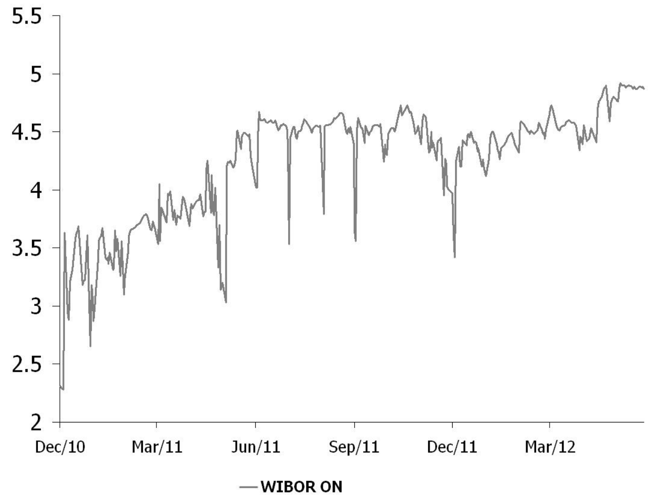
Money market

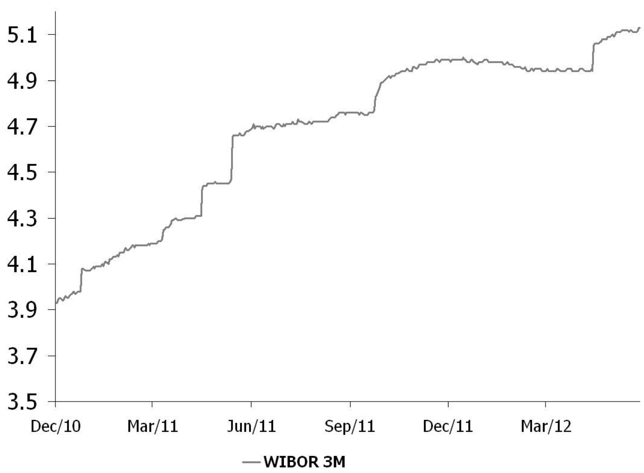
Interbank cash market is being replaced by the operations of the central bank

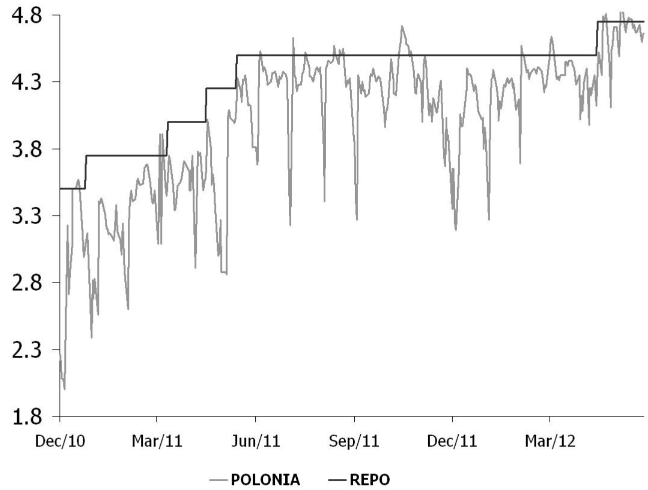
Cash still expensive despite the surplus. Looking at falling turnover on Polish Overnight deposits measured by the polonia index contribution, we have one conclusion: vast majority of the market is dealing exclusively with the central bank. Buying money bills is the main activity that limits the interbank exchange. So the central bank has finally managed to stabilise the polonia index but at a quite expensive cost (at least in our opinion), which is draining the liquidity on the shortest deposits interbank market. If there are no incentives to trade the overnight deposits how the market is expected to trade the longer tenors? Therefore, on the one hand the central bank would like to see longer cash transactions and on the other hand they kill the idea to trade even short cash among banks offering money bills not only on Friday but also mid-week if needed and even twice a day if the last day of the reserve is on Friday.

For us as pro market players it is a bit odd. We know how convenient it is from the liquidity management point of view, we know that the risk for the sector is lower if the sector cumulates the trades in the central bank, but we also know how important it is for the market to be able to regulate itself. Prolonged periods of the central bank's interventions via OMO can be devastating for credit lines and for ability to redistribute liquidity in an efficient way without the central regulator. Such conditions can also favour the rouge activity. If the interbank turnover is negligible, relatively small amounts are needed to disturb the rates. And this is what in our opinion happens. Having polonia at 4.66% at the same time when there is a deposit in the central bank for almost 1.5 billion pln gives a flavour to what we said. Food for thoughts...





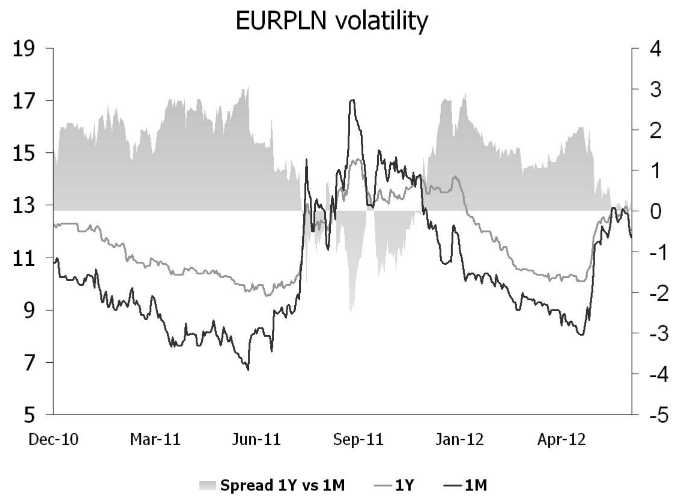




Forex

Current range persists. EUR/PLN was volatile in the wide 4.22/4.31 range. The global sentiment was to blame for all the swings. Looks like EUR/PLN, and to even larger extent USD/PLN is a EUR/USD on steroids. We are back in risk on/risk off motion, and that is likely to continue... the real question is if the risk rally in last weeks was solely US QE3 fueled? If the answer is yes, then we preparing ourselves for a harsher times.

Vols softer. We have noticed a healthy correction in Vols. The 1m EURPLN 1m ATM is 11.9% in comparison to last week 12.75% mid (respectively for 1 year ATM the mid now is 12.20 versus 12.75 last week). The skew and fly also was given by roughly 0.2%. The biggest looses were seen at currency spread (deference between USD/PLN versus EUR/PLN) which noted a 0.75 drop in the frontend and 0.5 drop in the backend.

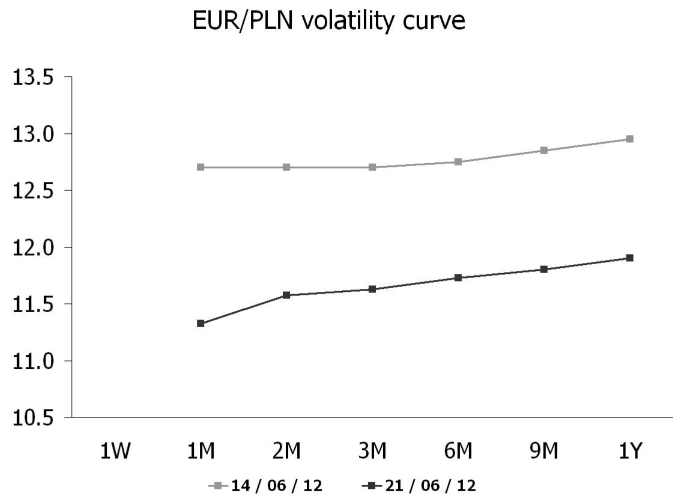


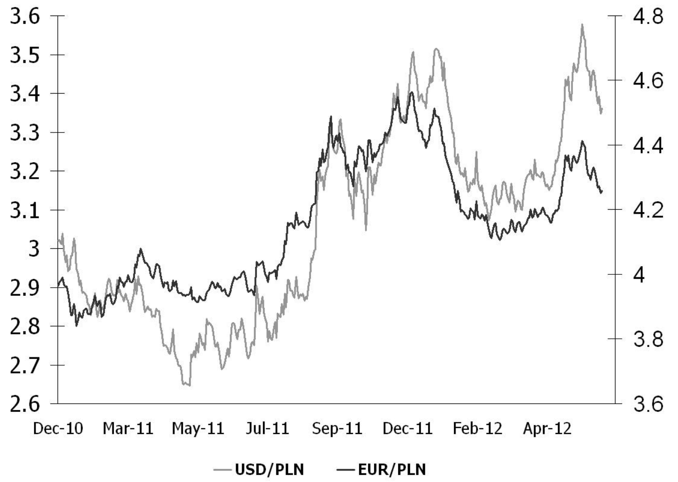
Short-term forecasts.

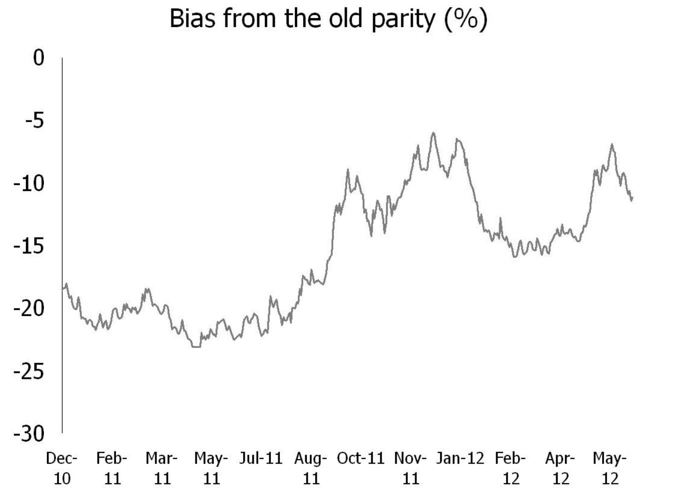
Main supports and resisances
EUR/PLN: 4.2200 / 4.3200
USD/PLN: 3.3000 / 3.4500

Spot. We actually think that lack of QE 3 is a game changer. We would like to buy EUR/PLN at 4.2450/4.2600 region, with a stop bellow 4.2200 and hopes for 4.30 + again.We look for a constellation of the higher lows to confirm that a solid bottom at 4.22/4.24 is firmly in place.

Derivatives. As we have experienced a very healthy supply of Vega, especially in the 3 month section, the market is currently consolidating the move. The Vega, skew and currency spread is still better offered around the curve. But if global sentiment will worsen, the EUR/USD curve will be better bid, and the demand for Vega would resurface very quickly...







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
6/15/2012	4.92	5.11	4.99	6.49	5.01	6.59	5.14	5.13	5.03	4.86	4.69	5.02
6/18/2012	5.00	5.11	5.00	5.04	5.00	5.05	5.13	5.15	5.02	4.85	4.68	5.01
6/19/2012	4.91	5.11	4.93	5.03	5.08	5.04	5.13	5.12	4.99	4.82	4.61	4.99
6/20/2012	4.90	5.12	4.92	5.04	4.93	5.05	5.15	5.13	5.01	4.82	4.60	4.98
6/21/2012	4.90	5.13	4.95	5.04	5.08	5.04	5.12	5.10	4.92	4.70	4.52	4.88

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
6/15/2012	6.590	4.813	4.860	4.742	4.750	4.884	4.805	5.256
6/18/2012	5.050	4.813	4.868	4.772	4.725	4.917	4.785	5.271
6/19/2012	5.040	4.813	4.805	4.738	4.665	4.860	4.715	5.168
6/20/2012	5.050	4.813	4.830	4.760	4.690	4.836	4.710	5.197
6/21/2012	5.040	4.813	4.830	4.707	4.690	4.787	4.710	5.140

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
6/15/2012	12.70	12.70	12.75	12.95	12.95	3.96	0.66
6/18/2012	12.63	12.53	12.58	12.55	12.55	3.96	0.66
6/19/2012	12.03	12.08	12.13	12.10	12.10	3.96	0.67
6/20/2012	11.78	11.88	11.98	12.05	12.05	3.88	0.67
6/21/2012	11.33	11.63	11.73	11.90	11.90	3.87	0.67

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/15/2012	4.2925	3.3971	3.5740	4.3039	1.4508	0.1683
6/18/2012	4.2680	3.3741	3.5536	4.2665	1.4589	0.1676
6/19/2012	4.2733	3.3916	3.5586	4.2980	1.4757	0.1672
6/20/2012	4.2503	3.3471	3.5397	4.2399	1.4779	0.1671
6/21/2012	4.2585	3.3617	3.5459	4.2165	1.4926	0.1665

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