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

Financial Markets Department
(business contacts)

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

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

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

Financial Markets Sales Department
(business contacts)

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

Jacek Jurczyński
structured products
tel. +48 22 829 15 16
jacek.jurczynski@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 Monday we expect Polish PMI come back to falling trend, but still not too abrupt. Substantial drops should emerge in employment index, which unexpectedly (and in our opinion unreasonably) rose in July. All the other indices summing to PMI remain below the 50 pts limit and we do not see much space for their growth (also concerning other economic indicators e.g. published by the Statistical Office). Such a scenario is also confirmed by the models based on German Ifo and PMI.

On Wednesday MPC repo rate decision and conference. MPC is not going to know the data publication for the coming month before it will be forced to make decision on rates. However, the big mistake in NBP forecast on GDP growth in Q2 suggests the moods in MPC should have tilted to the downside. Even before the publication governor Belka was speaking about the change of bias within the MPC („ongoing discussions are for rate cuts now"), after it can only be further tilted downside. Although we do not expect a change in rates at the September meeting, the revision of monetary policy guidelines and disappointing growth figures give room for much more dovish MPC statement. We then would not be surprised if governor Belka announces rate cut at the upcoming October meeting and the only room for speculation left will be the one concerning the scale of monetary easing.

Polish data to watch: September 3rd to September 7th

Publication	Date	Period	BRE	Consensus	Prior
PMI (pts)	3.09.	Aug	48.8		49.7
NBP repo rate (%)	5.09.	Sep	4.75	4.75	4.75

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	18/25-10-12	5000	4.361	7/19/2012
5Y T-bond PS0417	12/19-09-12	4000	4.361	8/1/2012
10Y T-bond DS1021	12/19-09-12	4000	5.349	5/10/2012
20Y T-bond WS0429	12/19-09-12	4000	5.563	5/10/2012

Macroeconomic forecasts

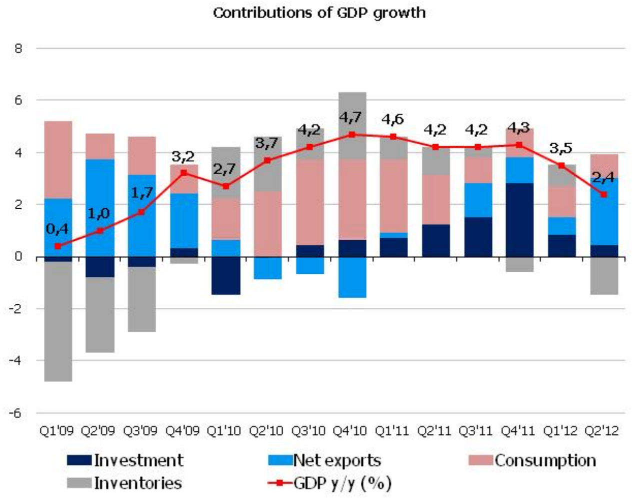
Wskaźnik	2009	2010	2011	2012 F	2013 F
GDP y/y (%)	1.7	3.8	4.3	2.5	2.1
CPI Inflation y/y (average %)	3.5	2.8	4.2	3.6	2.8
Current account (%GDP)	-1.6	-4.5	-4.9	-2.5	-1.5
Unemployment rate (end of period %)	12.1	12.4	12.5	13.5	14.4
Repo rate (end of period %)	3.50	3.50	4.50	4.25	3.50

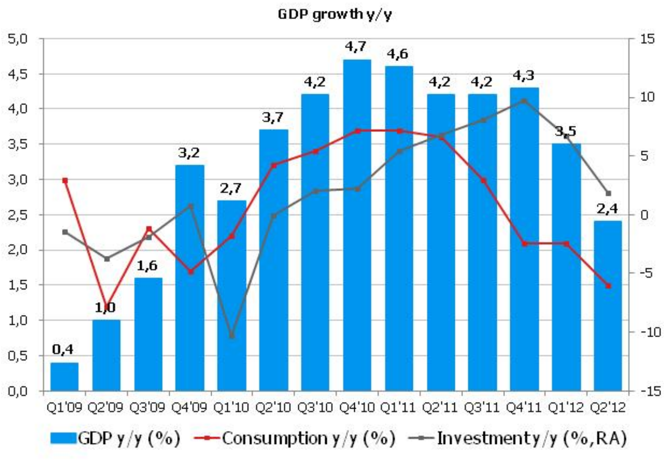
	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3 F	2012 Q4 F
GDP y/y (%)	4.2	4.3	3.5	2.4	2.0	1.4
CPI Inflation y/y (average %)	4.1	4.6	3.9	4.0	3.9	3.2
Repo rate (end of period %)	4.50	4.50	4.50	4.75	4.75	4.25

Economics

Q2 GDP figures very disappointing, infrastructure STOP, no EURO 2012 effect on consumption

GDP growth fell to 2.4% in Q2 from 3.5% in Q1. On paper this does not look like an avalanche but when we take into account a huge 0.5pp. mistake of NBP analysts (we believe that 2.9% figure quoted by Belka originated exactly from there), it is way below what was actually forged in MPC members' heads. Therefore the reading poses serious risk of earlier tightening. Our call is now for October.





As for the composition, consumption growth fell to 1.5% from 2.1% in the earlier quarter. Investment decelerated from 6.7% to 1.9% - judging from the value added in construction the gross of the burden was carried by infrastructure (deceleration from 9.6% to 1.4%). We think that - depending on the method of seasonal adjustment - seasonally adjusted growth in investment was negative in the second quarter. Domestic demand fell in Q1 by 0.2% (in the previous quarter it was +2.7%). It means that net exports contribution amounted to +2.6pp. - it is way above the figure that can be drawn from official balance of payments data. Therefore we expect a huge revision of NBP data (versus already published monthly readings) which can amount to +2 bn EUR (0.4% of GDP) in Q2 and be visible in the foreign trade data. The economy is rebalancing at a fast pace. It is no mystery then that this fact poses another, important argument in favor of faster rate cuts.

After the figures the market shed 8bps from the front end of the curve. The zloty continued to depreciate above 4.18 threshold (maximum just after the publication at 4.1955). Given the scale of surprise, reaction is normal, the more so since after accounting for this surprise Q3 is likely to show a print below 2% and the last quarter of the year will be dangerously close to 1%. We think consensus view will soon drift towards our pessimistic scenario. Short term rates should fall, government bond curve should steepen and ASW widen - there is no such thing as a „happy slowdown" in EM countries.

Upcoming publications to confirm the necessity of fast rate cuts

Just as we wrote in the previous piece, recent data confirm the necessity of (or give more room to) rate cuts and our call shifted towards October. It is obvious right now that the MPC have been stuck with its view to validate its flawed interest rate hike in May. Therefore along with the revision of monetary policy guidelines for the next year (to be presented at the September meeting) and with a substantial probability of relaxing them, the market will be given new food for thought. Moreover, there will be no salvation flowing from the real data - this month will be marked unanimously by more dovish figures. Let sum them up in a quick overview.

To start with the real sphere, August is likely to bring a **negative print of industrial output** (our call is for -0.7% y/y) after the corrective rebound in the previous month (5.2% y/y). The reading stems from negative working days effect (last month we had one more on annual basis, this time we are left flat) and from base effects from the last year (industrial output growth started to accelerate sharply in the summer 2011, led by the restorations of supply-chains). When we look at the GDP data, Q2 was marked by particularly strong decumulation of inventories. It means that forward looking (and hoping for lower demand) firms may have slowed output and report sold output only from the existing stock; such a reasoning is **consistent with much lower wages in manufacturing in July**. We expect this lower growth of wages to be quite persistent (only a small rebound in August to little above 3% y/y owing to some bonuses in mining). So the story is that enterprises cut current output, sell existing stock and decrease wages for their employees. They are not eager so far to cut down employment more aggressively (we expect another flat reading 0.0% on annual basis) but this will change as soon as the slowdown becomes more entrenched; so far business activity indicators for employment plans are volatile but more or less flat. The reading of **retail sales is set to fit into broader weakness of the economy** (we expect 3.7% growth vs 6.9% last month), the more so since some base effects affecting the sales positively have been wiped out.

On nominal side we expect both measures of prices (producer and consumer) to level off in August. In case of producer prices the fall is more substantial as the combination of zloty depreciation and more shallow and competitive market are powerful drivers of price cuts (if only there had been no increases in energy related goods, the reading would have been even lower), resulting in 2.9% growth in producer prices (versus 3.7% in the previous month). In case of consumer prices we expect a deceleration of inflation to 3.9% from 4.0% in the previous month; this time we expect more or less seasonal behavior of food prices which are offset by a small gain in fuel prices on monthly basis).

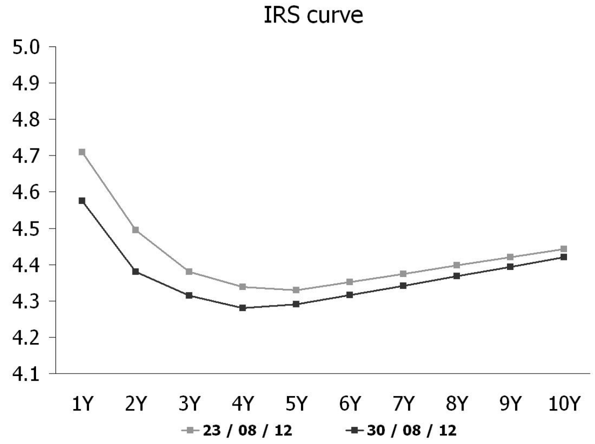
Bottom line - upcoming MPC meeting. MPC is not going to know the data publication for the coming month before it will be forced to make decision on rates. However, the big mistake in NBP forecast on GDP growth in Q2 suggests the moods in MPC should have tilted to the downside. Even before the publication governor Belka was speaking about the change of bias within the MPC („ongoing discussions are for rate cuts now"), after it can only be further tilted downside. Although we do not expect a change in rates at the September meeting, the revision of monetary policy guidelines and disappointing growth figures give room for much more dovish MPC statement. We then would not be surprised if governor Belka announces rate cut at the upcoming October meeting and the only room for speculation left will be the one concerning the scale of monetary easing.

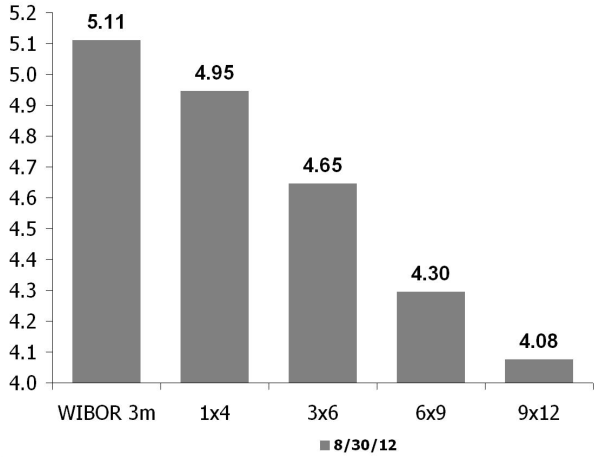
Fixed income

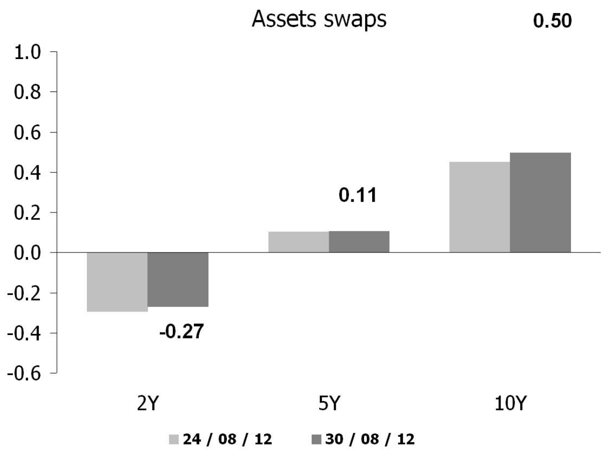
Slowdown becoming a fact

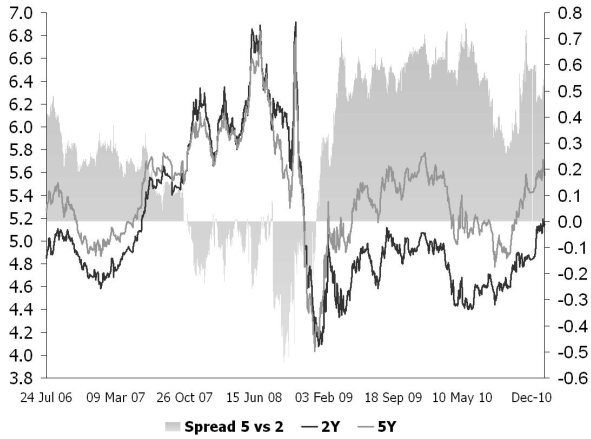
There were two significant events in the passing week. First was the publication of GDP data, which quite strongly surprised on the downside (only 2.4% growth in second quarter vs. 2.9% expected), the other one was a significant move on 3M and 6M Wibor fixings, which fell by 11-12bp within two days. With such a support, both rates and bonds rallied quite significantly, with front end gaining the most (2Y fell by 15bp, 5Y and 10Y by 8bp). Bond curve moved in smaller scale and steepened more.

It seems that economic slowdown is finally becoming a fact and we won't miraculuosly avoid it like we did last time. So it's now good time to start talking about rate cuts and scale of the easing. We don't think the MPC will decide to cut already next week, but they will definitely shift their rethorics to a dovish one, suggesting cuts to happen sooner rather than later. We still see value in front end of the curve, up to 2Y i rates and up to 5y in bonds. With economy slowing it's only matter of time when we start pricing in some risks in longer maturities, therefore bond curve should steepen and assset-swap spreads widen. No cut next week may however cause some correction, as scale of the move was large, but that would only create another buying opportunity ahead of September's data releases.







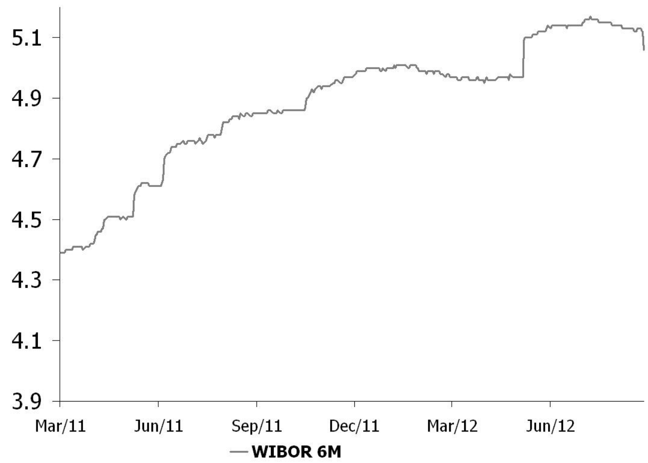


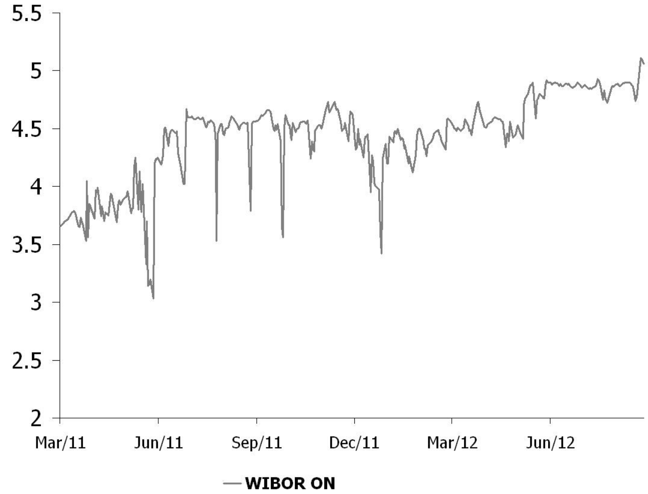
Money market

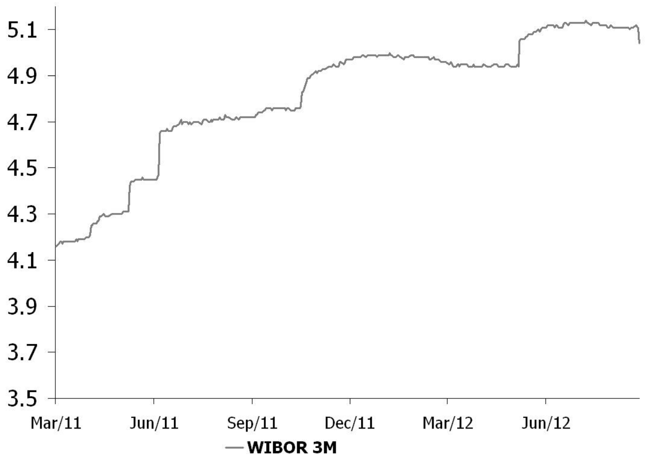
Strange scenario for liquidity Extremely unusual situation on liquidity last week. Despite the substantial surplus of the cash in the system (day before the last day of the reserve it reached 9 billion pln) shortest rates remained well above the main market rate (nearby 5%). We have no idea what could cause the liquidity problem. Historically and logically the rates should be dropping down to the deposit rate. Food for thought

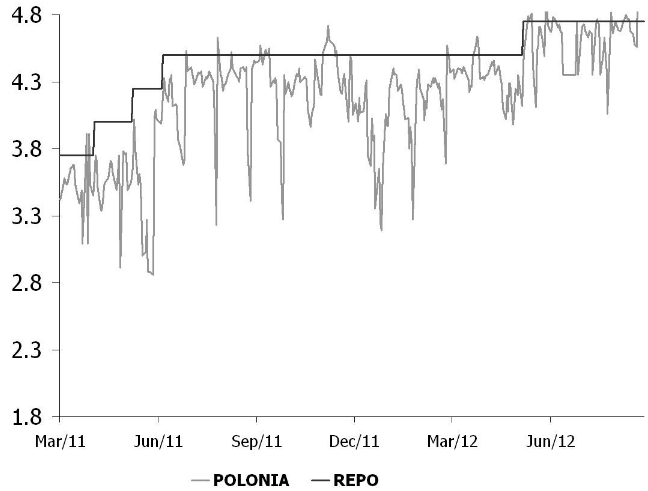
2Q GDP smashed the consensus scenario. The highlight of the week was the 2Q GDP figure, which came well below the consensus (including the central bank's forecast) at 2.4% vs 2.9 expected. It changes a lot, since the slowdown is coming much faster then it was assumed. The figure put huge downward pressure on rates that dropped 10-20 bps depending on sector. September becomes non zero event as far as the rates cut is concerned (just because the figure), nonetheless we think that the cycle will kick off in October (just to avoid a bigger shame after the hike in May).

Wibors down as locals are selling deposits. Moreover, some locals started to sell 6M interbank deposits that made the 3 and 6M Wibors come down 10-some bps. All in all the week was extremely bullish in terms of rates and the sentiment.







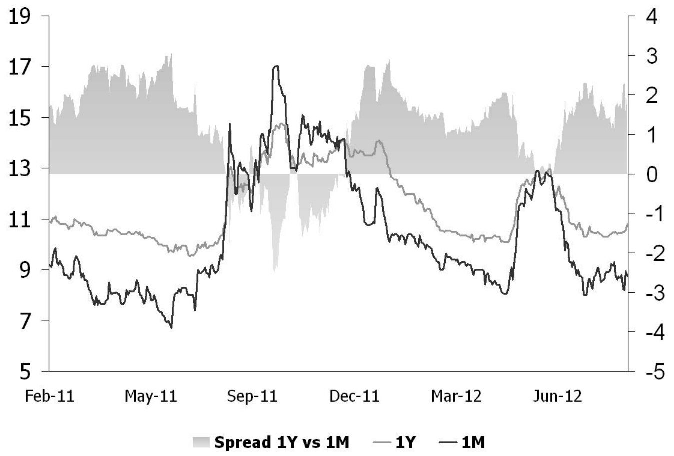


Forex

Higher in range Unheralded interest cut by central bank in Hungary was the catalyst for pushing the CEE currency to the fresh highs. Despite very quiet market on EUR/USD, EUR/PLN has broken the top side of its recent range at 4.10 and has exploded to almost 4.21 area on Thursday. The negative backdrop was also helped by the end of the month expiry and very weak Q2 GDP release which were also helping the rally. On Friday the meeting at Jackson Hole will set the tone for next week.

Spiked higher Losses of Zloty, plus the hefty rebounds in vols in major currency pairs (i.e. EUR/USD), have managed to lift the EUR/PLN and USD/PLN implied curves off lows. The short squeeze buying moved up the front end by 1.5% (1 month EURPLN jumped from 8.5% to 10.0% mid). The change on the 1 year was much smaller, roughly 0.4% (1 year is now 10.9% mid from 10.5% last week). The skew also shot aggressively up - risk reversals jumped around 0.5% (now 25RR 3M is 2.9%, 25RR 1y is 3.9%.). Currency spread (the difference between EUR/PLN and USD/PLN) now is around 7.3%.

EURPLN volatility



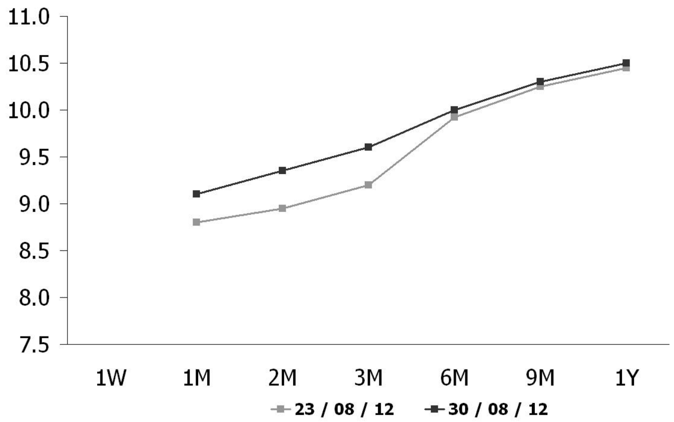
Short-term forecasts.

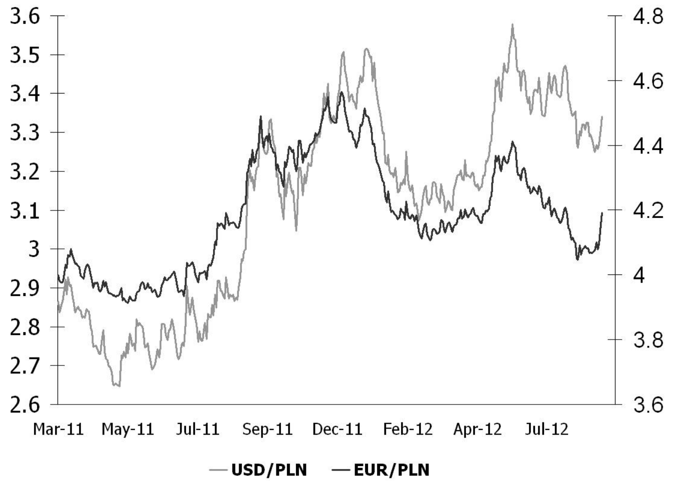
Main supports and resisances
EUR/PLN: 4.1500 / 4.2400
USD/PLN: 3.2700 / 3.4000

Spot. We would like to go long EUR/PLN again, on dips to 4.1350/4.1550 region with a stop below 4.10 and target to see 4.25 on the next move higher. We think that all the possible stimulus from Fed would be short lived, and the slowdown in Poland plus the rate cuts are the gloomy facts.

Derivatives. The strong floor for EUR/PLN vols (1m ATM 8%, 1y mid 10.0%), has already has proven itself several times in last 3 years. The Vols are still at levels which are attractive for buyers. We have added some vega to earlier long in backend Vega. The realized volatility, noted a healthy pick up.

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
8/23/2012	4.94	5.11	5.04	5.02	4.95	5.02	5.04	4.77	4.46	4.25	4.12	4.49
8/24/2012	4.76	5.11	5.04	6.49	4.99	6.59	5.02	4.77	4.45	4.23	4.08	4.48
8/27/2012	5.01	5.12	5.01	5.03	5.04	5.03	5.04	4.77	4.46	4.23	4.13	4.47
8/28/2012	4.88	5.11	5.04	5.02	4.99	5.02	5.05	4.74	4.44	4.21	4.12	4.44
8/30/2012	4.93	5.04	5.03	4.96	4.98	4.97	4.95	4.65	4.30	4.08	4.03	4.28

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
8/23/2012	5.020	4.813	4.495	4.197	4.330	4.442	4.442	4.882
8/24/2012	6.590	4.813	4.490	4.197	4.343	4.446	4.430	4.881
8/27/2012	5.030	4.813	4.500	4.209	4.343	4.415	4.440	4.866
8/28/2012	5.020	4.813	4.490	4.212	4.320	4.405	4.428	4.866
8/30/2012	4.970	4.813	4.380	4.112	4.290	4.397	4.420	4.917

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
8/23/2012	8.80	9.20	9.93	10.45	10.45	3.60	0.83
8/24/2012	8.25	9.15	9.90	10.50	10.50	3.60	0.83
8/27/2012	8.20	9.15	9.90	10.50	10.50	4.02	1.11
8/28/2012	8.95	9.50	9.98	10.55	10.55	3.60	0.78
8/30/2012	9.10	9.60	10.00	10.50	10.50	3.62	0.77

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
8/23/2012	4.0756	3.2488	3.3939	4.1358	1.4751	0.1636
8/24/2012	4.1012	3.2680	3.4147	4.1611	1.4740	0.1644
8/27/2012	4.0783	3.2570	3.3959	4.1385	1.4691	0.1641
8/28/2012	4.0950	3.2685	3.4091	4.1593	1.4713	0.1648
8/30/2012	4.1919	3.3397	3.4911	4.2473	1.4730	0.1681

Disclaimer