BRE BANK SA

POLISH WEEKLY REVIEW

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Comment on the upcoming data and forecasts

On Tuesday Statistical Office will publish the last package of August data. Our retail sales growth rate forecast is lower than market consensus and is supported by the latest negative surprises from labor market and industrial sector. Up to now base effects were supporting stable retail sales growth rate, but without their influence it should decrease even below 4%. Consumer spending is negatively affected by changes on the labor market - we expect the simultaneously published August unemployment rate to be the last stable value - our forecasts point to its growth even to 13,5-13,6% at the end of 2012. Already now seasonally adjusted unemployment rate grows.

Polish data to watch: September 24th to September 28st

Publication	Date	Period	BRE	Consensus	Prior
Retail sales y/y (%)	25.09.	Aug	3.7	5.9	6.9
Unemployment rate (%)	25.09.	Aug	12.3	12.3	12.3

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	10/18/2012	5000	4.361	7/19/2012
5Y T-bond PS0417	10/18/2012	4000	4.361	8/1/2012
10Y T-bond DS1021	10/10/2012	3000	4.944	9/19/2012
20Y T-bond WS0429	10/10/2012	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	2.2	1.5
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	3.25

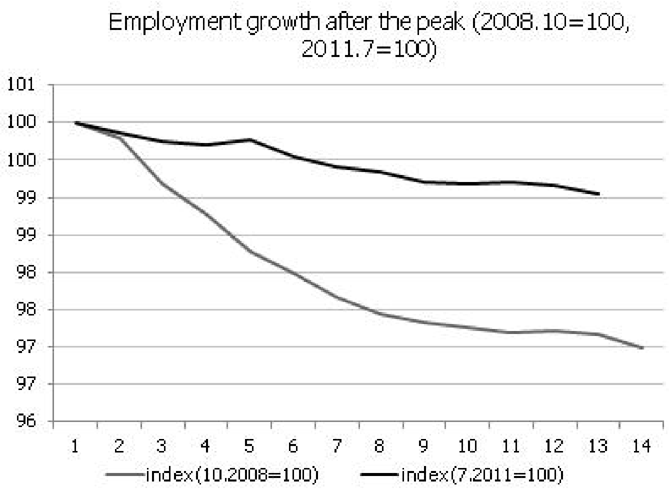
	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3 F	2012 Q4 F
GDP y/y (%)	4.2	4.3	3.5	2.4	2.0	1.3
CPI Inflation y/y (average %)	4.1	4.6	3.9	4.0	3.9	3.2
Repo rate (end of period %)	4.50	4.50	4.50	4.75	4.75	4.25

F - forecast

Economics

Much weaker data published in September...

Further payroll reductions, flattening trend in wages
In August annual growth rate of employment stagnated 7th month in a row in line with our forecast and market consensus. In absolute terms, employment decreased by 6.6k on the last month, which reflects the falling trend on the labor market, but still not so abrupt as in 2008/09 (see chart). We expect payroll reductions to become more pronounced in the coming months, along with the GDP trajectory.

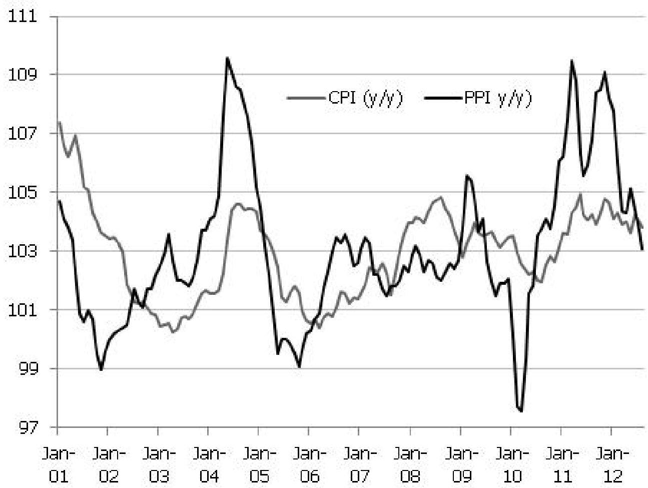


Only 0.5% industrial output growth in August
Output. Industrial output grew in August only by 0.5% y/y (less than 2% anticipated by the market) after it accelerated by 5.2% in July. In seasonally adjusted terms output grew by 1.7% after 4.7% in July. Such a decline was pointed not only by low PMI reading and SAMAR data concerning vehicles production, but also by weakening German industrial sector and statistical base effect from 2011.

As we expected July higher reading was not a fundamental improvement in the economy, but only an unusual one-off. Global trends are still negative (no significant improvement in the euro zone), zloty is stronger (therefore this shield is deactivated so far) which does not bode well for future readings. Along with mounting base effects next months are likely to bring industrial output below zero, including the forthcoming September reading.

Construction and assembly production. Construction output decreased by 5.0% y/y in August. There was a slight correction of July significant drop in infrastructure investment - it grew by 4.6% in August after 12.9% drop in July, but other categories continued declines. The reading confirms that public investment is set to generate negative contribution to GDP growth from Q3 onwards. We forecast negative investment growth (overall: public + private) at the beginning of 2013.

Producer prices. Producer prices increased in August by 3.1% y/y vs 3.7% in the previous month. This stems partially from neutral trends on commodities (growth concerns only oil), stronger zloty which allows for lower prices for importers, and partially from competitive pressure arising on a shrinking market. The latter cyclical easing of price pressure is set to intensify along with the more pronounced slowdown in the real sphere.
July was the first month for 3 years in which producer prices growth became lower than the growth recorded in their consumer counterpart (CPI) and in August this pattern strengthened. This „technical" reasoning allows for conclusion than the necessary condition for falling CPI has been already met. Indeed we also expect consumer prices to fall owing to more fundamental reasons.



Core inflation in the downtrend
In August core CPI (excluding food and energy prices) decreased by 0.2pp. to 2.1% y/y mainly due to lower apparel prices and base effects on communication category. All the other core indices published by NBP also decreased by 0.1-0.3pp. and we expect this downtrend to last in the forthcoming months on the one hand because of base effects and on the other reflecting the more and more visible economic slowdown.

...rationally should be enough for MPC to decide on rate cut in October

All the data published in September confirm our scenario of the overall negative trend in the economy. Lately published Minutes from the September MPC meeting point that the discussion was dominated by deepening internal and external slowdown. It was the first meeting after the negative surprise caused by the GDP publication for the 2nd quarter and the Council eventually noticed that apart from the global economic activity deterioration and its influence on Polish economy, weakening of the GDP growth is mainly attributable to a decline in domestic demand. With reference to economic outlook in the subsequent quarters some Council members emphasized much higher probability of substantially lower GDP growth than in the July NBP projection. Some concern was given also to the inflation issues and recent sharp rise in energy and agricultural commodity prices (but still „some" Council members believe that CPI will run below the upper limit for deviations from the target by the end of 2012 and only „few" pointed to the uncertainty of the pace at which inflation would decrease in 2013).

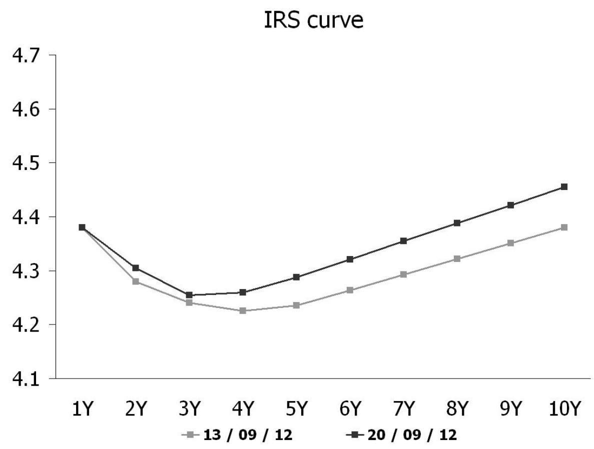
On the September meeting there were similar motions as in July (of 25bp. and 50bp. cuts) - both rejected. Although during the conference MPC tried to keep quite neutral stance due to reputational reasons, Minutes reveal more dovish rhetoric and make the door for monetary policy adjustment ajar („should the incoming data confirm further slowdown and the risk for inflationary pressure mounting remain limited"). Rationally all the data incoming so far in September should have removed potential obstacles to rate cut in October (according to our forecasts the forthcoming retail sales data should also fit into this picture). However, the latest statements of some MPC members pose slight doubts on whether the reputational reasons are not still dominant (Kaźmierczak wants to wait with the decision till November, Zielińska-Głębocka sees only two cuts in the whole cycle - 25pb. each).

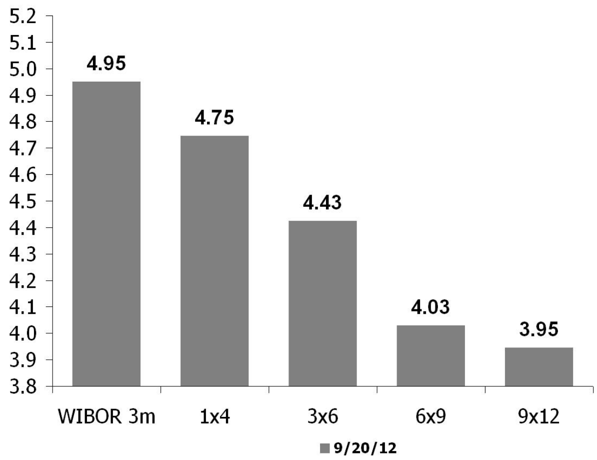
Despite the mentioned risks we stick to our rational scenario of 25bp. cut in October (in merits there are no arguments against it, instead of possible MPC's better mood). The release of a new NBP inflation projection in November will be another argument in favor of the easing cycle continuation, but postponing decision till November may then force MPC to more aggressive move and therefore make an impression of being late, especially that the projection should also dispel inflationary doubts (factors like relatively strong zloty, base effects, lack of gas prices growth should bring CPI down further in teh months to come). We expect MPC rhetoric to change substantially after the November publication - the realization of stronger slowdown and lower inflation will enable deeper monetary loosening in Q4'2012 and Q1'2013.

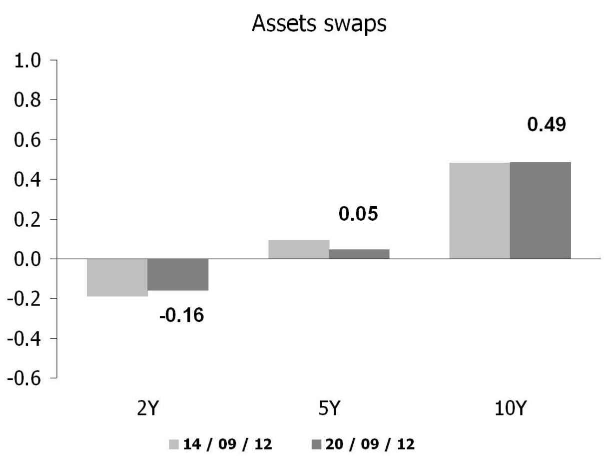
Fixed income

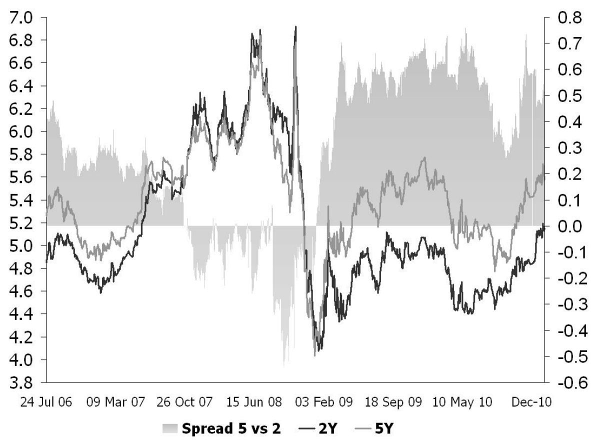
Behind the curve again?

Quite a volatile and awkward week behind us. Once the market has priced over 100bp rate cut cycle it started to steepen the yield curve aggressively especially in 1y1y fwd that topped 4.18% late on Monday. The similar action had been taken on the longer end of a curve pushing 2y10y spread up to 19 points positive with a decent selling interest of 10y treasury bonds. On the other hand both wages and industrial output data released this week showed the economy is slowing down rapidly that might ensure MPC to start the easing cycle in October. The awkward thing was some of the MPC members seemed not be fully ensured that economy needed an easing as quickly as it possible. Having in mind the monetary policy decisions for the last couple of quarters (especially the surprising hike in May) there might be a risk that easing cycle starting point would move forward making an uncomfortable situation both for the market and the Council. As the FRA fixings and the shape of a yield curve ceased to be logically predictable we changed our strategy by buying treasury bonds instead of receiving short term FRA contracts.





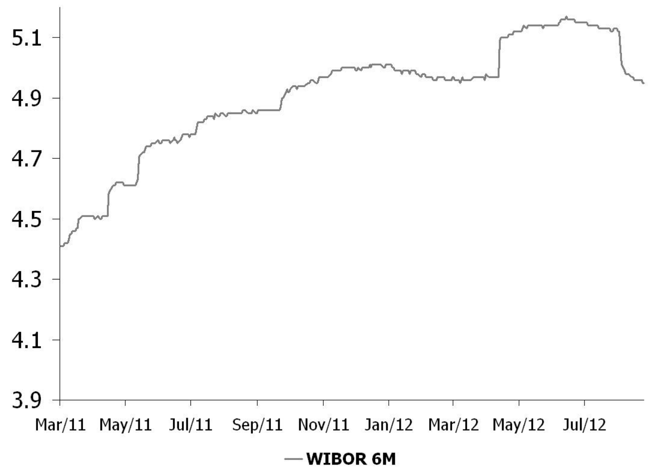


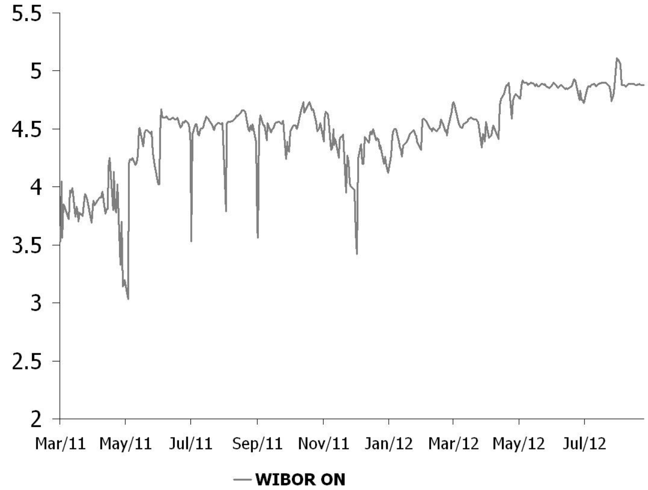


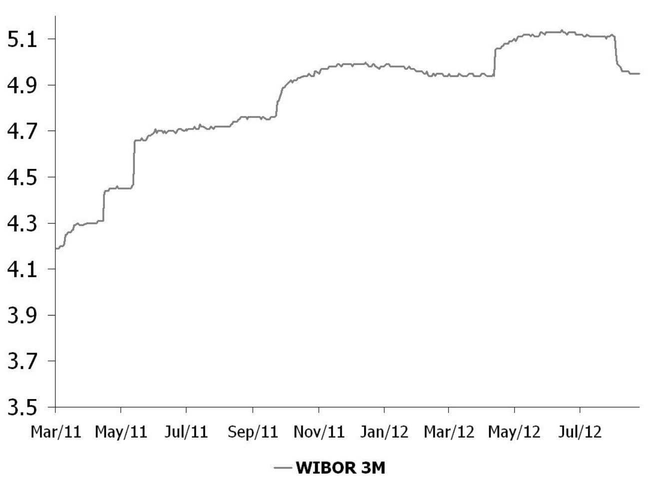
Money market

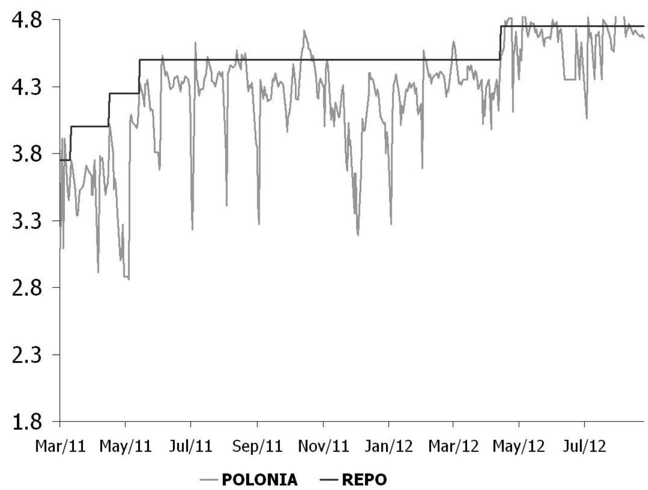
Expensive end of the reserve ahead. Stable week as far as the cost of carry is concerned, but it has a very good chance to end now. The end of the reserve requirements settlement period is going to be expensive due to large amount of the money bills that banks have bought during today's OMO (108 billion pln). We have no idea why banks started to like expensive short end. Money bills buyers may be again forced to finance those papers and even sell them with quite substantial losses (like last month). Nonetheless, for some reason it is going to happen again this month.

Very low IO still not convincing enough for some MPC members. In this perspective we have also another opinion. There are many voices that the interbank cash market became illiquid, especially for longer periods. The question is: how it can be liquid with such a severe sterilisation form the Central Bank side, that squeezes even overnight? Without liquid short term sector, one can forget about liquidity at all. Keeping carry that high by banks themselves is also illogical from the bond portfolios side, those papers have a very negative cost of carry in such enviroment. As for trading, we are just having bearish wave, which is hard to explain after last week's figures. All eyes were on the industrial production, which came very low at 0,5%. This should convince the MPC to cut the rates in October, since figures for September have very good chances to be much worse. But again logic has nothing to do with reality and some MPC hawks are still reluctant to act, they need more proofs for falling CPI and falling IO (sic!). Having history of really bad timing from the MPC side, they may wait and be behind the curve for much too long.





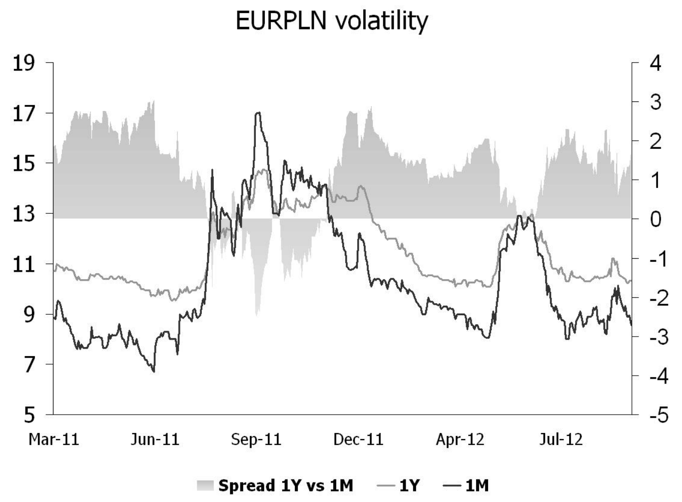




Forex

Volatility continues. On the buy the rumor, sell the fact approach, the EUR/PLN was able to rebound from 4.0490 to 4.1800 (high of the week). The rally stopped there and EUR/PLN has corrected lower to 4.1250. The big question is, do we have a lower top in place again? And we should head towards 4.00 next or it just a minor pullback before taking decisive charge at 4.20+. The scribe has no clue...

Slightly higher in the backend. The was a lot of smoke but little fire. The frontend is unchanged from the last week with 1m mid 8.8%. The backend of the curve is slightly higher 6m ATM 10% versus 9.8% ATM mid today. The 1 year is 0.1 higher, with 10.3 mid 1y currently. The skew and currency spread (deference between USD/PLN and EUR/PLN) are roughly unchanged.

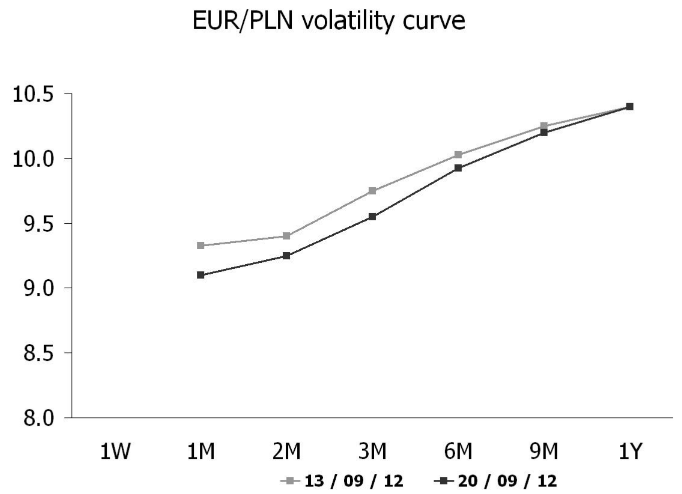


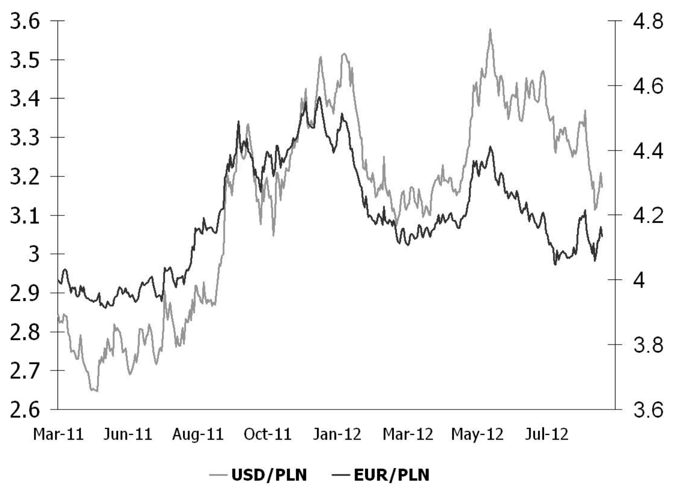
Short-term forecasts.

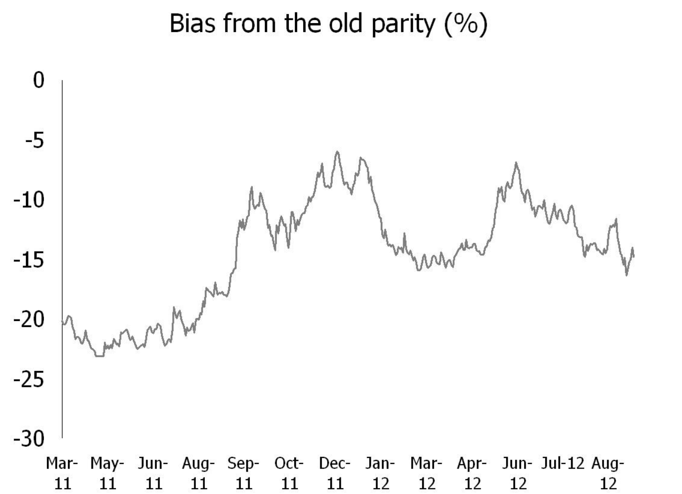
Main supports and resisances
EUR/PLN: 4.0500 / 4.1800
USD/PLN: 3.0500 / 3.2100

Spot. We don't see a high probability trade at the moment. We are slightly skewed to the upside in EUR/PLN as the rate cuts and Polish macro are sad facts. But timing is the key ...

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 are keeping the core long in the backend Vega in EURPLN.







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
9/13/2012	4.62	4.95	4.70	4.86	4.63	4.88	4.73	4.43	4.08	3.96	3.95	4.08
9/14/2012	4.76	4.95	4.73	6.49	4.70	6.59	4.76	4.44	4.11	4.00	4.00	4.14
9/17/2012	4.70	4.95	4.68	4.86	4.60	4.88	4.78	4.45	4.10	4.01	3.98	4.11
9/18/2012	4.61	4.95	4.58	4.86	4.53	4.87	4.77	4.44	4.08	3.97	3.99	4.07
9/20/2012	4.63	4.95	4.71	4.85	4.69	4.87	4.75	4.43	4.03	3.95	4.00	4.05

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
9/13/2012	4.880	4.813	4.280	4.123	4.235	4.300	4.380	4.902
9/14/2012	6.590	4.813	4.330	4.142	4.310	4.401	4.465	4.948
9/17/2012	4.880	4.813	4.345	4.142	4.345	4.384	4.505	4.982
9/18/2012	4.870	4.813	4.310	4.148	4.290	4.355	4.460	4.962
9/20/2012	4.870	4.813	4.305	4.146	4.288	4.334	4.455	4.941

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
9/13/2012	9.33	9.75	10.03	10.40	10.40	3.53	0.77
9/14/2012	8.90	9.30	9.78	10.23	10.23	3.53	0.77
9/17/2012	8.90	9.40	9.70	10.23	10.23	3.53	0.77
9/18/2012	8.95	9.45	9.88	10.33	10.33	3.53	0.78
9/20/2012	9.10	9.55	9.93	10.40	10.40	3.58	0.77

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
9/13/2012	4.1146	3.1852	3.3963	4.0990	1.4487	0.1681
9/14/2012	4.0584	3.1131	3.3379	4.0037	1.4421	0.1664
9/17/2012	4.0887	3.1207	3.3628	3.9814	1.4454	0.1672
9/18/2012	4.1217	3.1509	3.4012	4.0069	1.4505	0.1667
9/20/2012	4.1635	3.2092	3.4440	4.1056	1.4645	0.1677

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