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Comment on the upcoming data and forecasts

Monday's release of core inflation rate (we expect a slight decline) will follow last week's headline inflation release and show that inflationary pressures in the economy are receding. On Tuesday the Central Statistical Office will also publish the last part of September data. Our annual retail sales growth forecast is slightly more pessimistic than the market consensus but supported by last week's negative surprises in industrial production and corporate wages. A smaller number of working days and high statistical base in sales of food should also contribute to lower growth rate. We expect headline unemployment rate to increase slightly due to seasonal effects and deteriorating conditions in the real economy.

Polish data to watch: October 22nd to October 26th

Publication	Date	Period	BRE	Consensus	Prior
Core inflation y/y (%)	22.10.	Sep	1.9	2.0	2.1
Unemployment rate (%)	23.10.	Sep	12.5	12.5	12.4
Retail sales y/y (%)	23.10.	Sep	3.8	4.1	5.8

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	10/23/2012	5000	4.361	7/19/2012
5Y T-bond PS0417	11/8/2012	1000	4.361	10/4/2012
10Y T-bond DS1021	10/23/2012	3000	4.944	9/19/2012
20Y T-bond WS0429	11/8/2012	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	2.1	1.5
CPI Inflation y/y (average %)	3.5	2.8	4.2	3.6	2.7
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	1.6	1.0
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

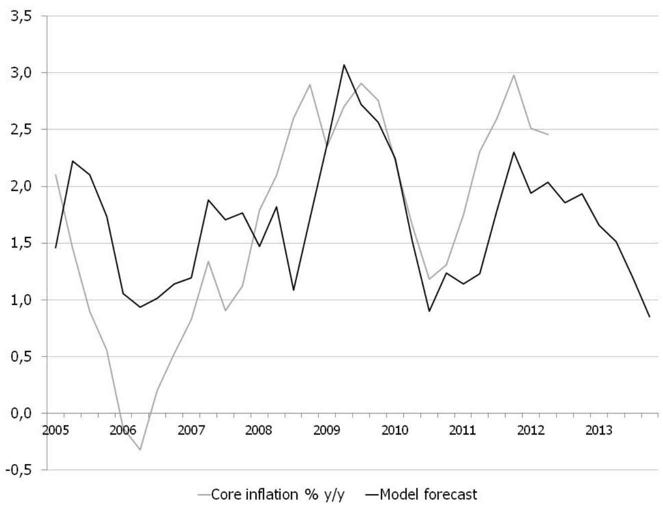
Economics

Nominal sphere: Inflation (unexpectedly) stable in September. Set to decline to NBP target within 2 quarters

Annual inflation, despite last year's low statistical base, remained stable in September at 3.8%. Market consensus placed the value at 4.0%.

The biggest surprise can be associated with food prices (declined by 0.1% on a monthly basis), especially with prices of vegetables (a 2.1% decline), a strictly seasonal product. It should be noted that other core categories also surprised us in September. Core inflation declined from 2.1 to 1.9% mainly due to a decrease in prices of cultural and recreational services and relative price stability in other categories.

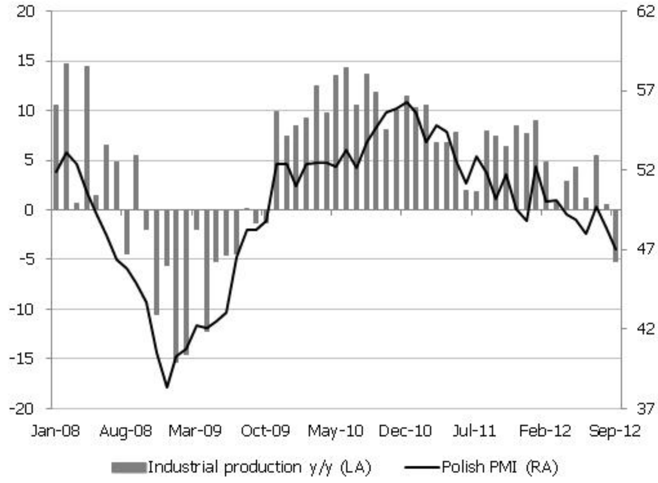
On to this month's perspectives. We predict that inflation will already fall within NBP's target band (1.5-3.5%) this month. At the end of the year inflation should decrease to 3.0% per annum. Furthermore, deceleration in inflation and core inflation is likely to be continued next year - at Q1/Q2 inflation will likely drop to NBP's target (2.5%). Expected behavior of core inflation rate is presented in the graph below. It should be noted that after this week's release risks to this forecast are mostly downward (i.e. that actual disinflation might be even faster than we anticipate).



Real sphere: Looming recession

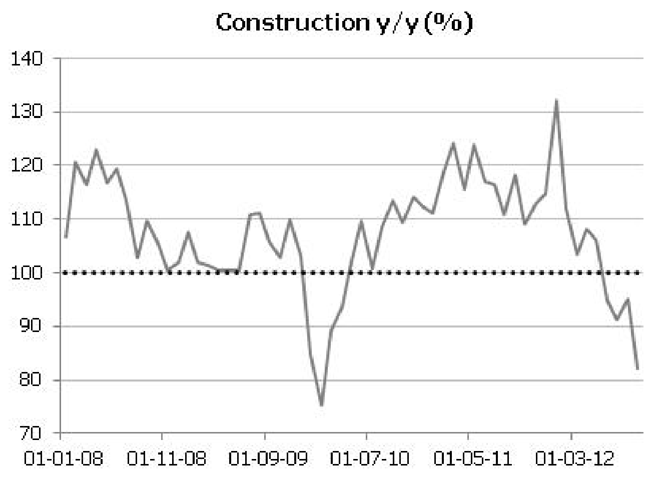
Significant drop of industrial production

In September industrial production dropped by 5.2% y/y after 0.5% growth noted in August. After eliminating seasonal factors, sold production of industry reached the level lower by 1.6% than in the corresponding month of the previous year and lower by 1.4% than in August. The data proves that recent decreases of industrial output are not a statistical anomaly, but reflect broad-based weakening for Polish economy.



As compared to September of 2011, a drop in production was reported in 27 out of 34 industry divisions (in August the respective number amounted to only 5 divisions). Slowdown in industry - the sector which resisted to the downturn for longest - is gaining momentum and will further translate into lower wages (corporate wages were only 1.6% yy up in September in nominal terms, but they fell by about 2% in real terms) and limitation of households' current incomes. When we add to this picture exceptionally low savings rate and its rather anti-cyclical recovery pattern, consumption outlook (which is now highly dependent on current income) becomes even more gloomy. In the forthcoming quarters one should expect strengthening of recessionary signs and further deterioration in the real economy. Similar scenario comes out of NBP's economic activity survey, which may be summarized as follows: deterioration of both current volumes and forecasts of orders and production (the percentage of companies planning to reduce production was only slightly lower - by 5pp. - than those which plan to increase it). The index declined not only for firms offering their products in Poland, but also exporters (the biggest declines of industrial output were reported in export sectors such as computers, furniture, motor vehicles). Situation in Europe (expectations of upturn are still being moved into the future) and south-east Asia (expected fiscal stimulation in China) gives also very limited space for external boost for Polish economy. In October the headline reading of industrial production may slightly recover, but only due to positive difference in working days.

Construction output in September was lower by 17.8% than in the same month of the previous year and higher by 2.2% in comparison to August 2012 (after eliminating the seasonal factors respective numbers amounted to -9.5% and -2.0%). Annual declines were recorded in all divisions of construction: construction of buildings (-22.9%), civil engineering (-14.9%) and specialized construction activities (-13.9%). The data support scenario of further weakening of investment activity, which was also reflected in the NBP's economic activity survey mentioned above. In Q4'2012 corporate investment activity is set to slow down with lower share of new investment projects and declines of planned outlays on fixed assets.



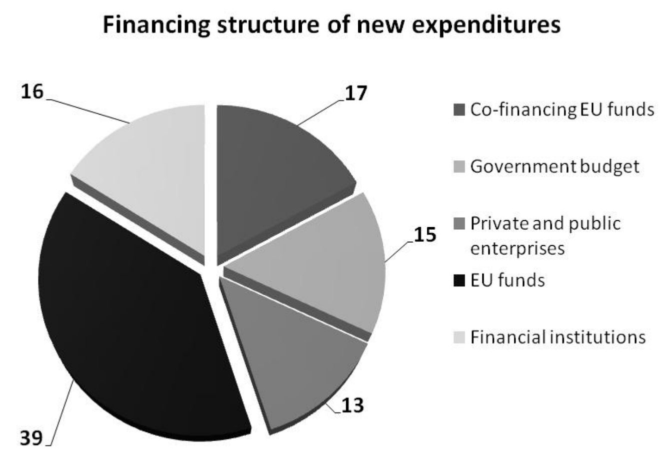
Rate cut in November a done deal
Past week brought new recessionary data, which prove that slowdown has only just begun and it is too early to speculate about a rebound. **We expect that in Q3'2012 GDP growth deteriorated to about 1.6-1.9% y/y, compared to 2.4% in Q2'2012. In Q4'2012 it may fall to about 1% and in further quarters even below zero.** Simultaneously, inflation data surprised with an unchanged headline reading and stronger decline of core index. A clear and decreasing trend in inflation is a direct rebuttal of arguments used by those members of the Monetary Policy Council who stand against any monetary easing even in case of a substantial deterioration of economic growth. Therefore, after this week the fate of interest rates in November seems to be sealed. Minutes from October meeting and recent statements of MPC members confirm this expectation, as they reveal that the Council has been waiting with the decision mainly for new inflation projection, which will be published in November (some treat it even as a formal criterion). Further data releases should lead to consecutive cuts (in December, January, etc.).

The second expose of Polish PM: How large will the fiscal stimulus be?

In the so called „second expose" Prime Minister D. Tusk proposed several measures leading to investments amounting to 300 bln PLN (until 2015) and 460 bln PLN (until 2020). Key elements of this pro-investment strategy are:

1. The „Polish Investments" programme. BGK will receive new capital in the form of shares of state enterprises and generate more than 40 bln PLN of new investment credit. However, it has to be remembered that sufficient demand for investment credits and debtors' reliability are crucial for the programme to take off.
2. Investments in the energy sector (60 bln PLN until 2020).
3. Shale gas exploration and extraction (50 bln PLN, incl. private capital).
4. Construction of new roads and motorways (43 bln PLN until 2015).
5. Railway investments (30 bln PLN until 2015).

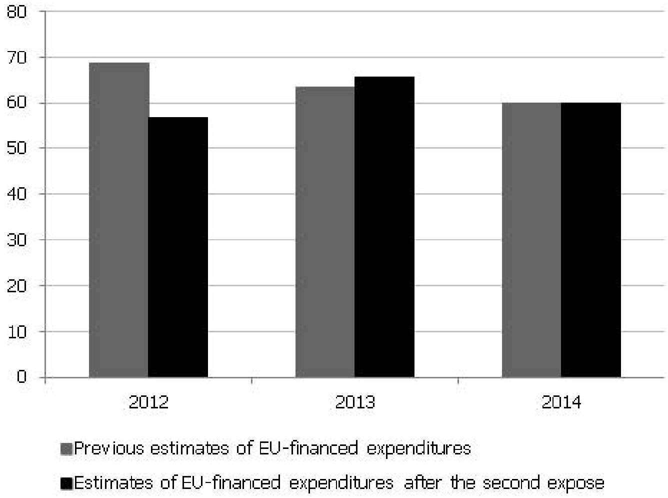
Furthermore, the Prime Minister promised to introduce cash accounting for VAT, continue the deregulation process, extend the length of maternity leave (costing 2 bln PLN annually), and reform labor offices (the offices' performance will be evaluated on the basis of their effectiveness in combating unemployment).



It should be noted that the overwhelming majority of proposed investment (including roads and railways) has already been included in government strategic documents and other plans. For instance, the Ministry of Regional Development planned to smooth out spending of EU funds from the current programming period, allowing for public investment to be carried out during the gap between the end of the current period (2013) and the effective beginning of the next EU funding cycle (2015) as well. Thus, the „Polish Investments" programme and proposals regarding the BGK (neutral for fiscal deficit both according to Polish and ESA 95 methodology) are the only novel part of the whole stimulus.

In one breath, the Prime Minister also outlined private and public investments in the energy sector. Their level stated in the speech, we should treat as the maximum attainable and not as the realistic and feasible level. The maximum effect on public finances (an increase in government expenditures) is estimated to reach on average 1 percent of GDP in years 2013-2020, assuming that the investment programme will be financed according to plans unveiled by J. Rostowski and M. Budzanowski on a press conference (see the graph above). In years 2013-2015 the size of the fiscal stimulus will not exceed 1,8 percent of GDP annually (on average) and the effect on the government budget will be less than 1 percent of GDP. One can observe that almost a half of stimulus is co-financing and not a direct budget expenditure.

Obviously, the government will be tempted (because of substantial deterioration in internal aggregate demand) to focus its stimulus in 2013. However, the issues of tender procedures (although Polish Railways are increasing their ability to absorb funds, it still remains below 20%) and inadequate planning in the energy sector constraint the size of investments in 2013. Additional impact on the government budget might not exceed 1 percent of GDP (note that a novel approach to infrastructure projects i.e. „Polish Investment" programme will not result in higher fiscal deficit). It has to be remembered that these funds are not new (de facto already earmarked and differences are minor - see the graph below), therefore the stimulus must remain limited in the nearest future.

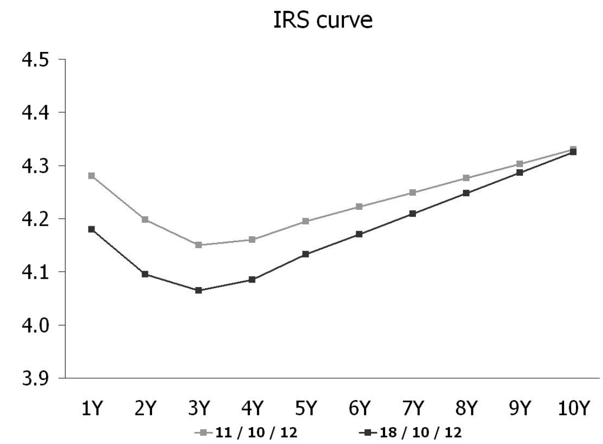


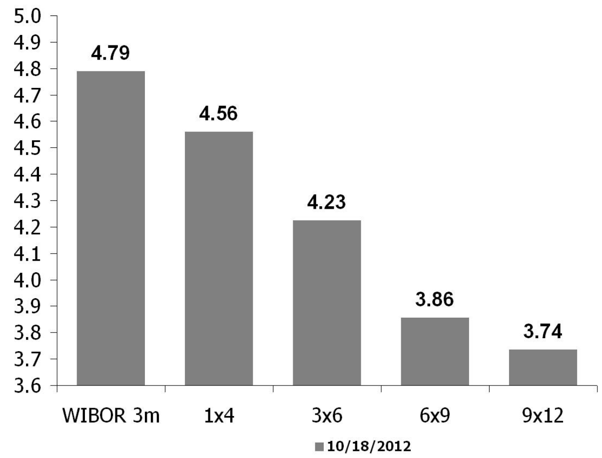
As a result, budget deficit should not significantly increase beyond 3,5-4,0% of GDP (as compared to 2,2% of GDP written in the convergence programme; the government has already suggested that budget deficit might exceed 3% GDP in 2013). This level does not guarantee that Poland won't be subject to Excessive Deficit Procedure (EDP). Therefore, the stimulus should not affect investors' expectations regaring the supply of government bonds. It is our impression that maintaining economic growth through limited fiscal stimulus, tolerated by the financial markets, and yields being still attractive versus core markets govies are sufficient arguments to conclude that demand for Polish bonds will be adequate.

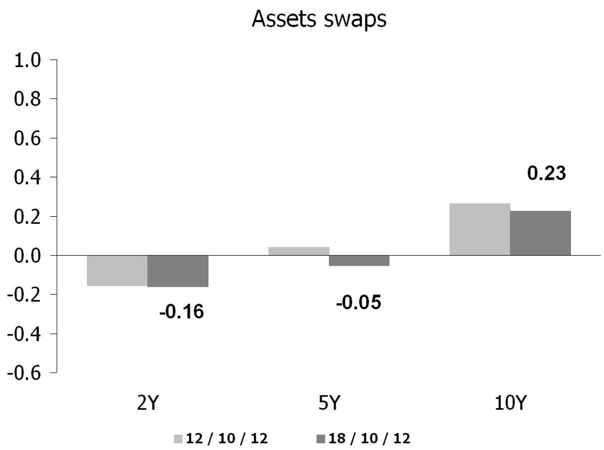
Fixed income

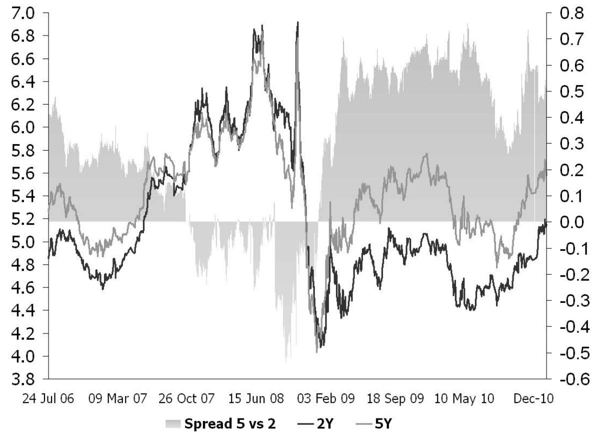
Getting steeper

Last week was very good for Polish bonds and rates. Economic releases surprised on the downside with CPI staying flat at 3.8, industrial output printing negative and wages falling to below 2%. MPC members both doves and hawks started to acknowledge need for a rate cut and it looks like a deal done. CPI and GDP projections will probably support cut not only in November but also in December. We are also entering a period of quite fast deceleration in CPI index due to base effect from the last year. CPI is likely to hit below 3% by the end of the year. Also during past week we had quite substantial fall in Wibor rates, additionally Wibor curve is inverted for the first time in some more than 5 years. Next week we will have retail sales which should not change the macro story and auction in OK0714 and DS1023 (old 2y and new 10y bond). Into MPC meeting (early November) and auction market is going at all time highs in 5y bonds (4% YTM) and close to all time highs 10y bonds (4,50% YTM) - we are neutral here. Our skepticism about further rally comes from 1) positioning, we must admit inflows into PLN bonds, but we wonder about the quality of the flow 2) risk premium that market keeps constantly adjusting to monetary policy instead of overall risk surface. Market is very complacent about prospects of fiscal policy, 0.5pp slippage is already in prices, our view though is that Poland may start to become very vulnerable to credit risk. We got used to constant surprises on the fiscal side, but this year budget revenues apart from NBP's profit are running below plan (especially VAT). It is hard to expect that with lower CPI and GDP dynamics next year budget revenues will meet plan. There is also no one off from NBP to be expected due to current level for EURPLN exchange. Moreover, MinFin is keen to prefinance more than 20% of borrowing needs this year (not a wonder looking at yields), but we expect that actual deficit will be larger (35 bio planned for next year) and we don't exclude a risk of budget adjustment bill sometime next year once slowdown will start to materialize more visible on the income side. Some of this will be offset but easier monetary policy, but here again question is how much is priced in. Rates look to go to 3.5% in 9 months from now, which we don't know MPC is ready for. All in all, we look at valuations as rich. We think that risk is underestimated. But while the music play . . . we take opportunity to embark on the lifeboat.





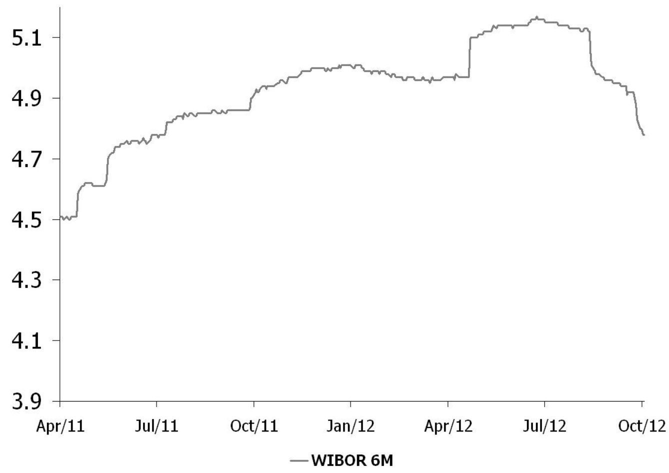


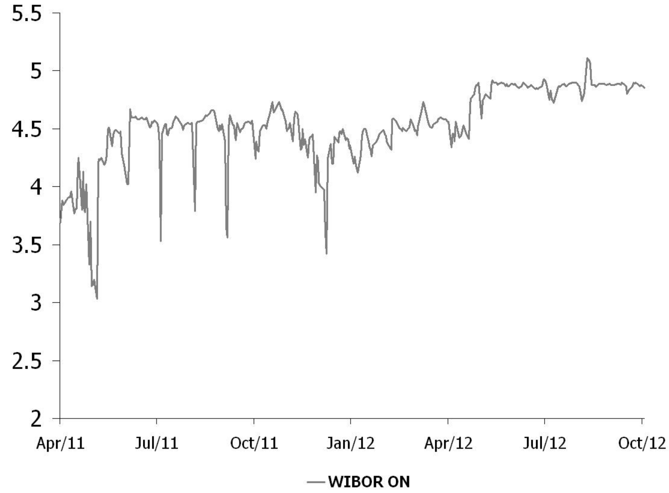


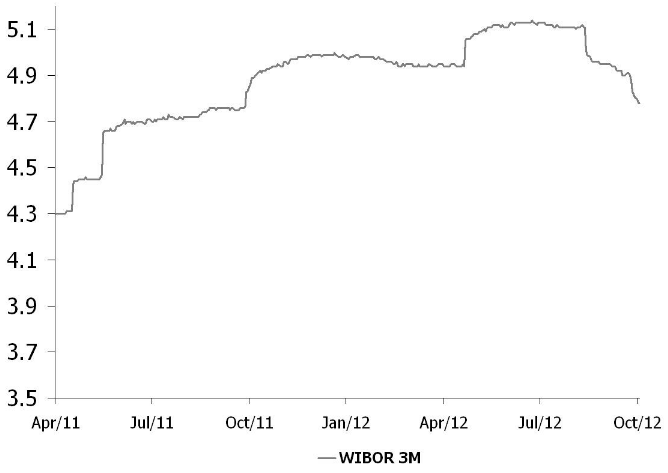
Money market

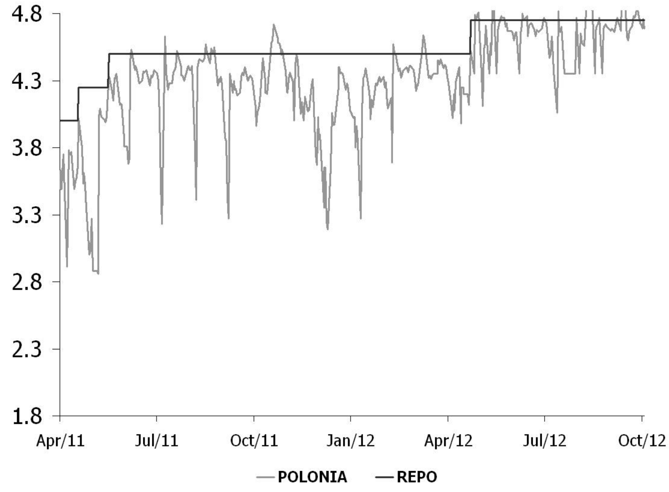
Liquidity can be volatile next week. Low demand during today's OMO (95 bln pln vs 106 bln pln supply). It should provide a cheaper financing for the coming week. Huge maturity and coupon payments of the October bonds should be sterilised by the Ministry of Finance itself, via reduced BSB activity. Also additional OMO seems to be very likely next week.

November cut is a deal done. Continuation of the rally after figures (flat CPI vs expected rise plus higher negative figure for industrial output). November cut looks to be a done deal, and it is fully priced. What new can occur is a play for 50 bps cut, however we think that 25 bps is still the most probably scenario for the next MPC meeting.





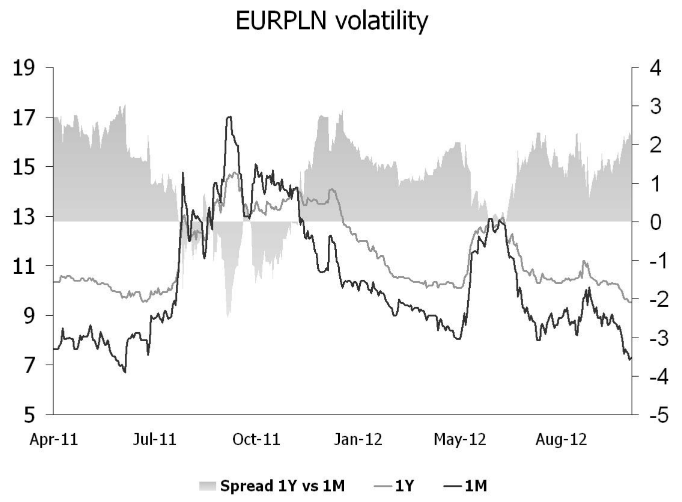




Forex

Waiting for the MPC. With global environment developments being neutral to positive, seems like the MPC meeting (7th of November) and it's rate decision is the most likely catalyst for PLN in the near future. The foreigners investors are already heavily positioned in Polish bonds, and their reaction to the decision will be decisive for Zloty. At the moment the base scenario is a 25bp cut, but 0 or 50bp cut can not be definitely excluded. Till then we expect the range 4.05/4.13.

Sell-off continues. Fierce sell-off continues, and the body of the curve is the main victim . The 6m ATM EUR/PLN dropped to 8.7% mid from 9.1 % last week. 1m and 1y ATM is lower by 0.2%, respectively to 7.0% and 9.4% today. The currency spread (difference between USD/PLN - EUR/PLN) is lower by 0.2% but risk reversals are holding ground, unchanged from last week.

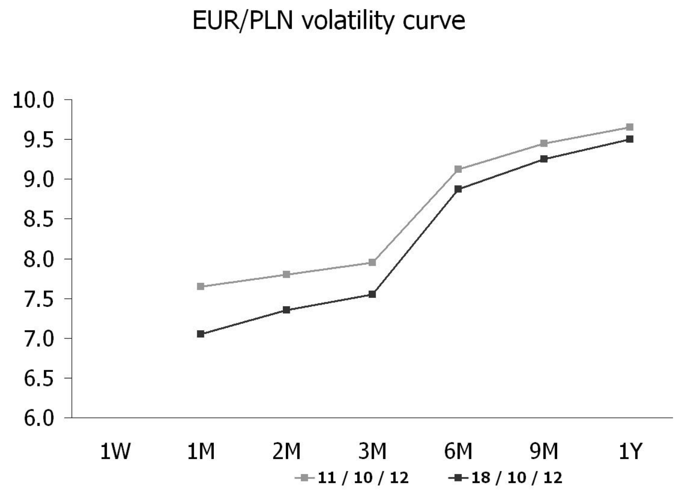


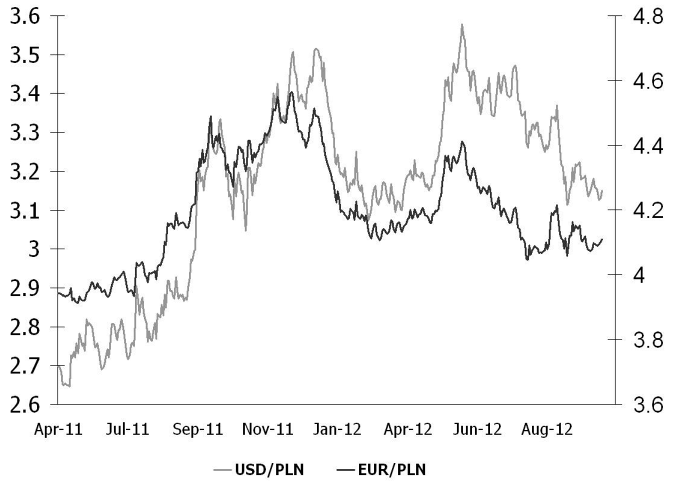
Short-term forecasts.

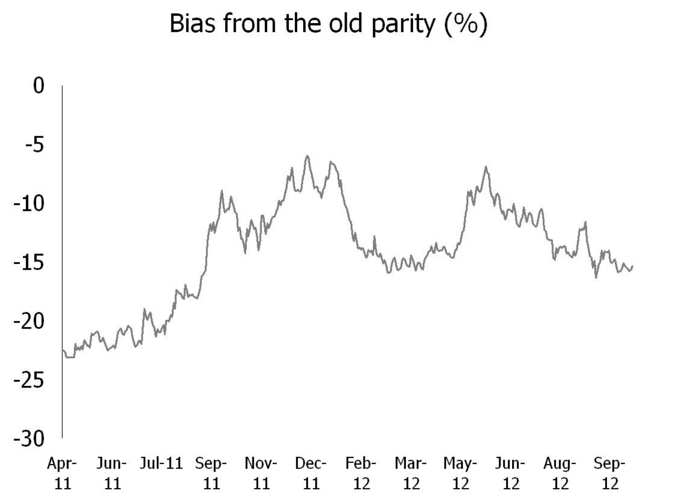
Main supports and resisances
EUR/PLN: 4.0500 / 4.1400
USD/PLN: 3.0500 / 3.2100

Spot. Playing the range is still the name of the game in this environment. We are still bids for EUR/PLN at 4.0450/4.0550 with stop below 4.0350 and hopes for 4.1000, or offers 4.1150/4.1250 with stop above 4.1400 and eyes on 4.0700.

Derivatives. The sell off in the middle and backend is quite impressive. Implied volatilities are at the lowest levels since „Lehman time" but there is still no bids. The closer to year end, the more protection from Minister of Finance PLN may have (last year EUR/PLN was sold by MF to secure that debt to GDP ratio is under control). As the consequence the chances for spikes in vols are less likely in the coming weeks...







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
10/12/2012	4.61	4.83	4.60	6.49	4.55	6.59	4.63	4.34	3.94	3.81	3.82	3.94
10/15/2012	4.65	4.80	4.63	4.70	4.58	4.70	4.63	4.27	3.91	3.80	3.82	3.92
10/16/2012	4.61	4.80	4.60	4.70	4.55	4.70	4.62	4.27	3.91	3.79	3.79	3.92
10/17/2012	4.58	4.79	4.59	4.69	4.50	4.69	4.63	4.27	3.89	3.76	3.76	3.88
10/18/2012	4.67	4.78	4.59	4.68	4.50	4.68	4.56	4.23	3.86	3.74	3.75	3.85

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
10/12/2012	6.590	4.813	4.173	4.018	4.153	4.193	4.300	4.565
10/15/2012	4.700	4.813	4.140	3.993	4.136	4.187	4.300	4.568
10/16/2012	4.700	4.813	4.143	3.984	4.153	4.163	4.335	4.604
10/17/2012	4.690	4.813	4.120	3.917	4.140	4.162	4.340	4.598
10/18/2012	4.680	4.813	4.095	3.933	4.133	4.081	4.325	4.551

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/12/2012	7.53	7.85	9.03	9.68	9.68	3.45	0.75
10/15/2012	7.45	7.80	8.98	9.58	9.58	3.45	0.75
10/16/2012	7.20	7.70	8.88	9.53	9.53	3.45	0.75
10/17/2012	7.30	7.70	8.88	9.53	9.53	3.46	0.75
10/18/2012	7.05	7.55	8.88	9.50	9.50	3.44	0.75

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/12/2012	4.0957	3.1577	3.3866	4.0251	1.4542	0.1644
10/15/2012	4.0920	3.1565	3.3835	4.0179	1.4669	0.1642
10/16/2012	4.0889	3.1438	3.3822	3.9855	1.4686	0.1641
10/17/2012	4.0940	3.1261	3.3839	3.9707	1.4656	0.1653
10/18/2012	4.1034	3.1314	3.3928	3.9568	1.4817	0.1659

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