BRE BANK SA

POLISH WEEKLY REVIEW

December 14, 2012

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Comment on the upcoming data and forecasts

The remaining macroeconomic data comes out this week.On Tuesday, the CSO will publish its monthly labor market data (corp. wages and employment). We expect that current trends will be continued: employment slightly decreased on an annual basis and nominal wage growth declined (downtrend in manufacturing and no bonuses in mining). On Wednesday, industrial data will be released. High statistical base from last year, a mixed outlook from business tendency indicators and only marginal difference in working days add up to a zero annual growth in industrial output. We also expect PPI inflation to drop almost to zero, as commodity prices have fallen, PLN depreciated only slightly and firms' expectations have decreased even further. Thursday's release of core inflation data will confirm conclusions drawn from last week's CPI release. Finally, on Friday the CSO will publish retail sales data and its unemployment figure. The former is likely to be down from the previous month, as high base in fuels reaches its apex and the difference in working days narrows.

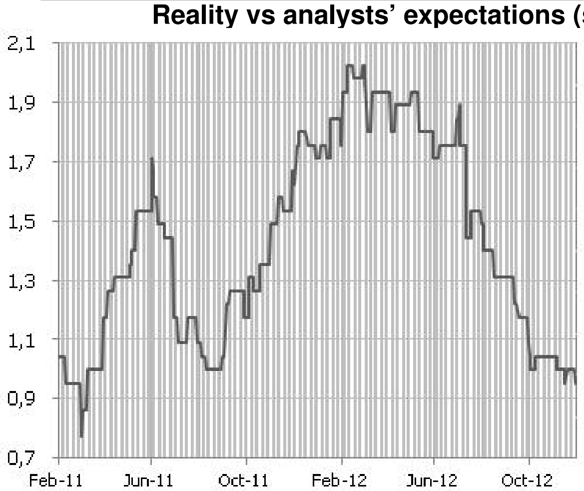
Polish data to watch: December 17th to December 21th

Publication	Date	Period	BRE	Consensus	Prior
Employment y/y (%)	18.12	Nov	-0.2	-0.2	0.0
Corp. wages y/y (%)	18.12	Nov	2.4	2.8	2.9
PPI y/y (%)	19.12	Nov	0.2	0.1	1.0
Sold production of industry (%)	19.12	Nov	0.0	0.3	4.6
Retail sales y/y (%)	21.12	Nov	1.5	2.8	3.3
Unemployment rate (%)	21.12	Nov	12.8	12.8	12.5

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	-	5000	3.856	10/23/2012
5Y T-bond PS0418	-	4000	3.900	11/8/2012
10Y T-bond DS1021	-	3000	4.496	10/23/2012
20Y T-bond WS0429	-	4000	5.563	5/10/2012

Reality vs analysts' expectations (surprise index* for Poland)



Comment
Slightly lower as inflation turned out to be even lower than most analysts anticipated. The rest of November's data comes out next week, possibly with a lot of negative surprises.

* Surprise index presents in a synthetic way how the market was surprised by macroeconomic releases (it is constructed on daily basis as weighted average of differences between selected releases and Bloomberg forecast consensus).

Our view in a nutshell

Fundamentals

- Consensus view on the Polish economy still too optimistic (we expect more growth forecasts downgrades). Polish economy is set to enter recession in H1 2013 (negative GDP growth in y/y terms). We see H2 2013 in only slightly more positive light, though, mainly due to global recovery.
- External developments in H1 2013 (euro zone fails to accelerate soon) at most neutral for Polish exports (and GDP).
- Polish government committed to the convergence path, though in an unorthodox way. Very limited room for fiscal stimulation due to limited financial markets tolerance for higher debt. GG deficit no higher than 4% (minor impact for the economy, support for Polish bonds).
- Weaker domestic demand is the main cause of recession. Consumption stagnates due to extremely low savings rate (the value of assets also fell recently) and negative real income growth. Infrastructure gap puts public investment growth into (substantial) negative rates; private investment suffers from weak outlook (tipping point in corporate lending).
- Inflation set to moderate in the near term on statistical effects (high base from 2012) and in mid-term on lower core inflation (close to 1% in mid 2013). CPI inflation at 2.0-2.5% in January 2013 (gas price cuts announced in 1-2 months uderpin the scenario).
- Monetary easing cycle started already in November. Realization of our scenario set to force MPC to cut more than they previously think is necessary. We bet on >150bps easing.

Financial markets

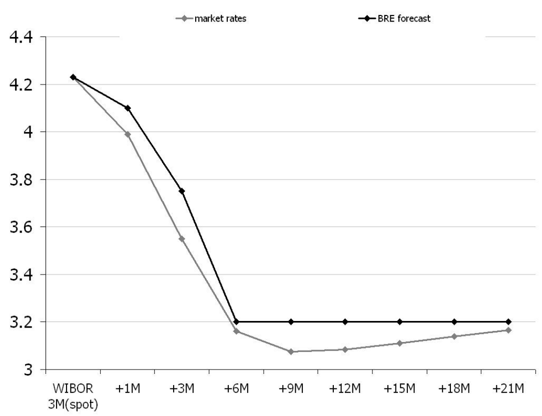
- Zloty moderately weaker towards the end of the year. Despite weaker economy and lower rates usual cyclical pattern for EURPLN set to be distorted by more balanced fiscal policy and accompanying lower current account deficit.
- Despite recent rally there is still room for lower rates in the short (much lower inflation, monetary easing, carry trades) and the long end (mild risk-off supports Polish bonds, no signs of any credit risk rise in the next weeks, if not months). As the ongoing C/A rebalancing is rating positive, the process should prove positive for Polish bonds.
- As global recovery and intra euro spreads compression continues and core yields rise accordingly 2013 quite likely not a "bond year" on Polish market as well. Polish bond yields should still remain low by historical standards, though.
- Volatility lower due to so-called ECB put.

BRE forecasts

	2008	2009	2010	2011	2012 F	2013 F
GDP y/y (%)	5.1	1.6	3.9	4.3	2.1	0.5
CPI Inflation y/y (average %)	4.3	3.5	2.8	4.2	3.7	1.9
Current account (%GDP)	-5.3	-1.6	-4.5	-4.9	-2.6	-2.0
Unemployment rate (end of period %)	9.5	12.1	12.4	12.5	13.0	14.2
Repo rate (end of period %)	5.00	3.50	3.50	4.50	4.25	3.25

	2012 Q1	2012 Q2	2012 Q3	2012 Q4 F	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.6	2.3	1.4	0.7	-0.7	-0.2	0.9	1.9
Individual consumption y/y (%)	1.7	1.2	0.1	-0.2	0.2	0.5	1.0	1.5
Public Consumption y/y (%)	-0.8	0.5	0.2	0.0	1.0	1.0	1.0	1.0
Investment y/y (%)	6.0	1.3	-1.5	-4.0	-6.0	-5.0	-5.0	-3.0
Inflation rate (% average)	3.9	4.0	3.9	2.9	2.0	1.7	1.8	2.0
Unemployment rate (% eop)	13.3	12.4	12.4	13.0	13.2	13.3	13.5	14.2
NBP repo rate (% eop)	4.50	4.75	4.75	4.25	3.75	3.25	3.25	3.25
Wibor 3M (% eop)	4.94	5.13	4.92	4.10	3.75	3.20	3.20	3.20
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.20	3.10	3.20	3.40	3.50
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.95	3.70	3.80	4.20	4.40
EUR/PLN (eop)	4.15	4.22	4.12	4.14	4.20	4.15	4.10	4.00
USD/PLN (eop)	3.11	3.35	3.20	3.23	3.16	3.07	3.15	3.08

F - forecast

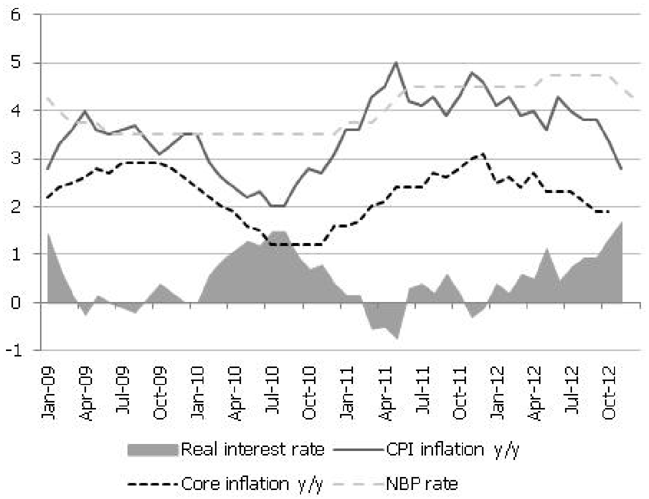


Economics

Inflation falls even faster

Annual inflation declined from 3.4% to 2.8% in November, along with our forecast and slightly below market consensus of 2.9%. On a monthly basis, consumer prices rose by 0.1%. The main reason for such a large decline in inflation are high statistical base effecs from last year (fuels, food and new list of reimbursed drugs).

In November, just as in October, no surprising price changes happened, thus observed inflation reflects mainly the downtrend. Prices rose only in two categories, health services (0.4% m/m) and food (0.5% m/m), but these were due to seasonal factors. Fuel prices fell by 2.4% on a month-to-month basis. Housing prices (one of the most important categories) rose increased only by 0.1% from the previous month. Core inflation net of fuel and food prices probably declined from 1.9 to 1.7% in November.



In the coming months annual inflation rate will continue to decrease. In December inflation will be very close to the NBP's target of 2.5% and in the first quarter of 2013 it will fall even lower. Disinflation in the next few months is determined by deteriorating economic activity (core inflation could drop to an annual rate of only 1.0%) and the lack of energy price hikes (resulting in massive base effects from last year). We also bet that inflation rates will be revised downward after January, as new weights are introduced into the consumer goods basket (decline in relative energy prices should cause income effects shifting consumer spending away from fuel and food).

As inflation is falling faster and growth prospects are constantly deteriorating, MPC's stance should become more dovish. Even now the majority of MPC members (including the pivotal Mr. Hausner) acknowledges that inflation could fall even below NBP's target band. We believe that market expectations for rate cuts (despite the fact that over 150bps of easing has already been priced in by the market) will be constantly primed by further data releases from the real economy.

May we expect a positive outlook attached to Polish rating in 2013?

Although country-rating is a complex business, we decided to find a simple formula that matches an index of macroeconomic data to country rating. Our idea was to draw variables from the data published for European countries by the European Commission (EC) and the respective forecasts (Autumn round of economic forecasts) and construct and index of macroeconomic data that maximizes the (linear) correlation between actual country rating and the macro index. Our aim was to obtain the linear equation describing country rating as of 2012 and then see what is going to change given the EC forecasts for 2013.

The analysis carries therefore 2 obvious features. First of all, it allows to compare which countries are over- and underrated given the mean rating as expressed by the regression line (static approach, valuable but biased due to model errors). Secondly it allows for a dynamic approach which is to see which rating a country would hypothetically have if the rating was governed by our regression line drawn on the basis of 2012 data and then to see what is going to change in 2013. We prefer this line of reasoning since it almost (let's leave math aside) cancels out (remember? We measure changes!) the error terms of the model. There is also a third, a non-obvious line of reasoning. Having proven a relation between macro index and rating (the higher the rating, the higher the index) we are able to see which macro indicators Poland should improve to have rating raised.

We are well aware that technical details are for geeks (therefore for us and fellow analysts and economists) and the results are for real investors. Therefore we jump to conclusions, pushing the details (still in a very short form, we can offer more on very well-motivated request) to the end of this short article. At this stage it is important to know that we measure macroeconomic data in 3-year averages in order to at least smooth some cyclical fluctuations (3-year moving average has always more inertia). Such a method of smoothing fares far better than shorter averages and single-year data in explaining rating dispersion between countries under investigation.

Conclusions:

1. **Static approach reveals that Poland is around 2 notches underrated. Conforming to the rating implied by the regression line would result in A1 Moody's rating and A+ ascribed by Fitch and S&P.**
2. **Dynamic approach does leaves less optimistic message. According to the EC forecasts for 2013 Polish rating barely changes between 2012 and 2013. Therefore the improvement in macro indices for Polish economy is not substantial enough (remember we make comparisons with European average all the time since rating mirrors also a relative picture of the country).**
3. **Poland can do better in 2013, though, if current account deficit was better conforming with the European average (close to 0) and inflation would fell more quickly to 2,8%. In such circumstances would the rating be raised even by 2 notches. Our estimates suggests that Poland is set to undergo a substantial improvement in those fields, however, as we measure in 3-year averages, the immediate impact for rating may**

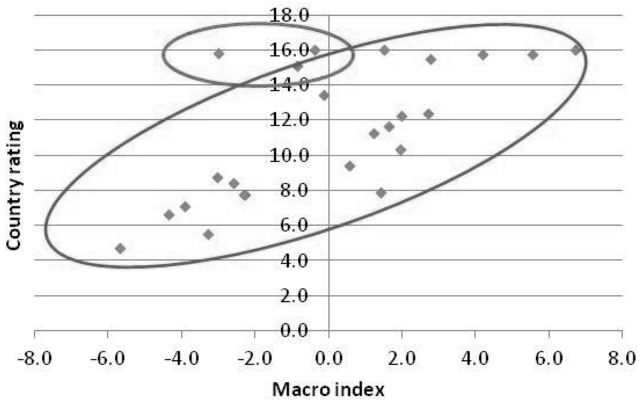
be negligible. It does not exclude, though, that forward looking rating agencies would praise Poland for external and internal rebalancing with an upgrade of rating outlook towards positive. Such a reasoning is set to support the ongoing popularity of Polish bonds among foreign investors.

Details:

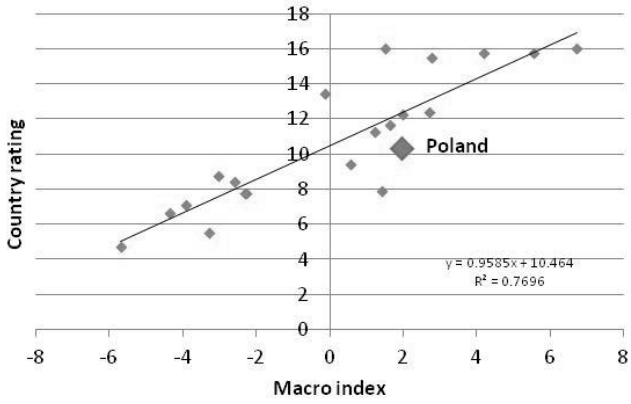
The chosen form of macro index was a sum of the following variables, measuring domestic and external balancing of economies and their structural potential as well, with predetermined sings used in summation (in parentheses): GDP growth [+], GDP per capita (level) [+], Potential GDP growth (as quoted by the filters used by EC) [+], C/A balance [+], General Government Balance (ESA standard) as a percent of GDP [+], Public debt as a percent of GDP [-], Share of public expenditures in GDP [-], ULC growth [-], Unemployment rate [-], HICP inflation [-]. The variables were mechanically smoothed to look beyond cyclical fluctuations (3-year averages) and presented in standardized form in terms of multiples of standard deviations from the European mean (it allowed for additivity).

Alphabet ratings of countries under investigation (at least one B) were transformed to numerical ones using the simple rule: the higher the rating, the higher the number. Therefore the maximum rating a country can have is 16 which corresponds to triple A. We also made small adjustments according to rating outlook attached to each rating (a country with negative outlook was given a penalty of -0.25, negative watch was more severely punished with -0.5).

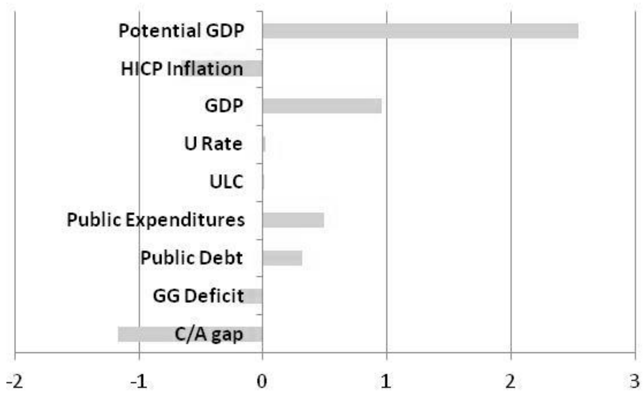
After eye-balling the scatter plot of ratings and the macro index we decided to exclude the Great Britain, France and Finland from the sample, as those countries seemed severely over-rated given their negative macro index. The picture confirms they are really the odd ones out (for the skeptics: results obtained for the whole sample does not substantially change our conclusions and do not change them at all as far as detection of fields of improvement for the Polish economy is concerned).



Results from the trimmed sample are the following (the functional form of regression line is given on the graph). Remember that we are dealing with cross-country data, therefore 76% R-square is a fairly good result.



As we already presented all relevant conclusions on rating considerations, at the end we would like to elaborate more on Polish macro indicators with relation to its European counterparts that make for the current Polish rating. We present them on the graph, scaled by standard deviation and with relation to the European mean. The one thing to know at the moment is that the higher the macro index (and hence the higher the macro indicators scaled by standard deviation), the higher the rating.



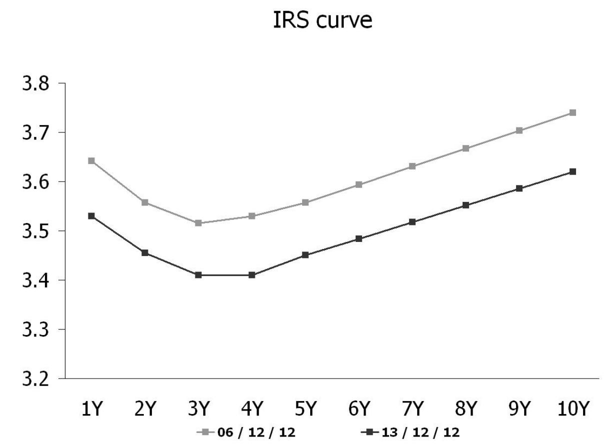
As we already mentioned in conclusions, the damping factors for Polish rating are HICP Inflation and C/A gap now. Both contribute negatively to the rating and - when set close to European mean - would result in 2 notch upgrade of the Polish economy. A huge positive contributor for Polish rating is potential GDP and current GDP growth reading. Although the latter is set to remain cyclically low in the coming quarters, it will be counterbalanced by a still decent growth of potential GDP. We think that the potential growth of Polish economy deserves even a more positive look as recent huge amount of investment in infrastructure is set the raise productivity over the long and medium term. Therefore huge infrastructure effort undertaken in recent years (that spoiled fiscal indicators at the same time - but still not as much as in Europe) should be looked together with its possible influence on productivity. We think that in these circumstances a change of Polish rating outlook towards positive does not seem pure wishful thinking, the more so since the Polish government is determined to stick to fiscal consolidation path.

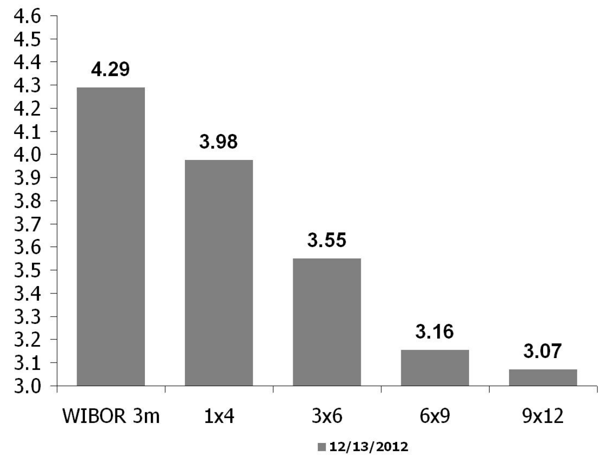
Fixed income

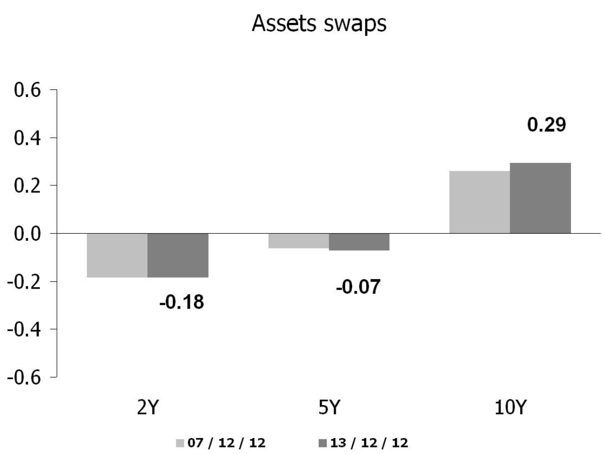
Rates bottoming out

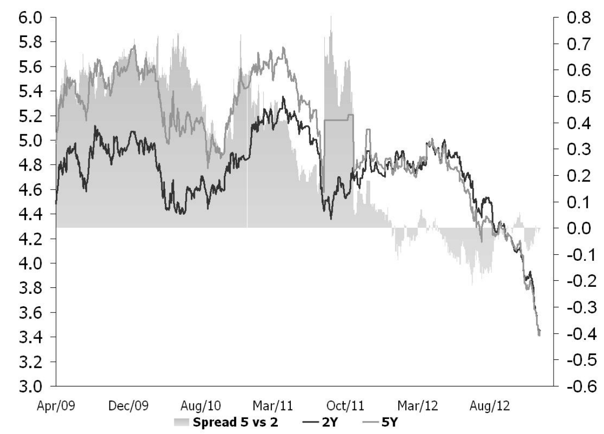
This week PLN rates and bonds reached fresh lowest levels again, however, after pricing in 200bp cuts in this cycle the rally has somehow lost momentum. Only the very front of the curve remained supported by falling Wibor rates, while the rest consolidated/corrected by few bp. Recent comments from MPC members do not clarify the situation at all, the Council is still divided between doves, who either want to continue easing as CPI keeps falling or even call for deeper cuts (Bratkowski - 'rates should be brought to 3% in 1Q already') and hawks who would agree for another rate cut in January and then wait for further developments. Therefore, the question at the very moment is about the scale of next month's move. Not excluding 50bp, we don't really think that's a likely outcome, especially that recent data, however supportive, weren't enough to either convince the hawks or cause some nervousness about the state of the economy among the doves. There were some comments from PM Tusk recently about necessity of Poland's declaration on joining the Eurozone. We don't think, however, that it will be followed by any firm decision and won't become market mover after all.

Considering the holiday season ahead and very thin and vanishing liquidity on the market, we wouldn't really call for any significant bets here. However we don't exclude some correction from current levels, which would allow the market to become bullish again next year, once we see another cut and again weaker macro data which would strenghten expectations of monetary easing even further.





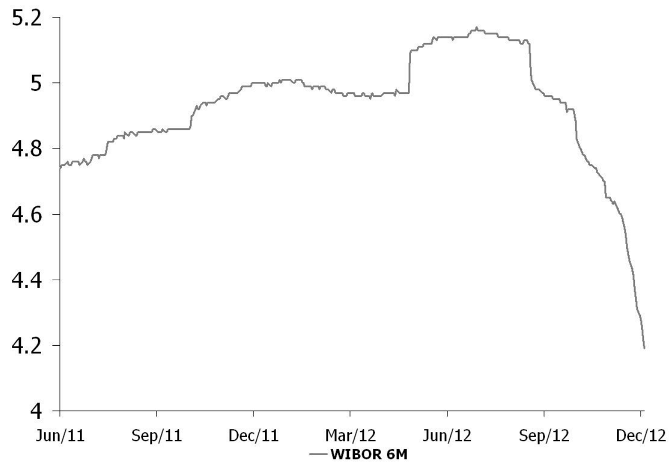


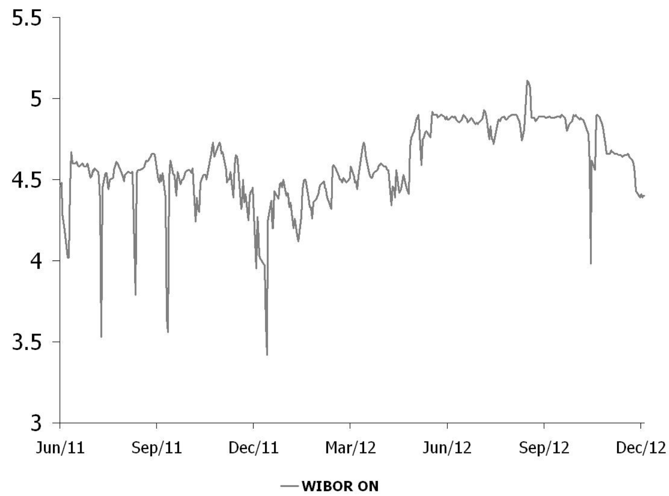


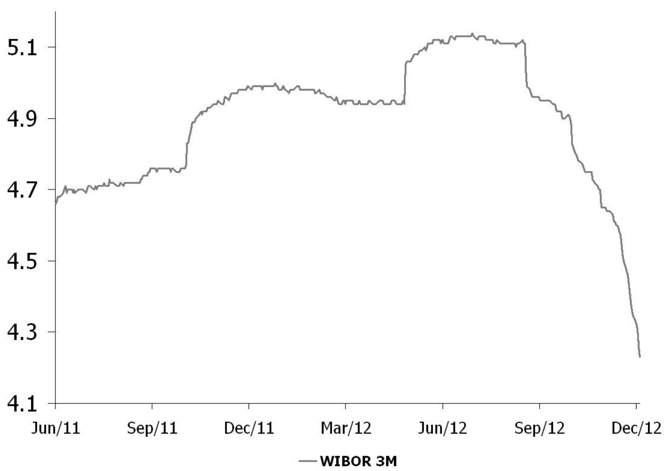
Money market

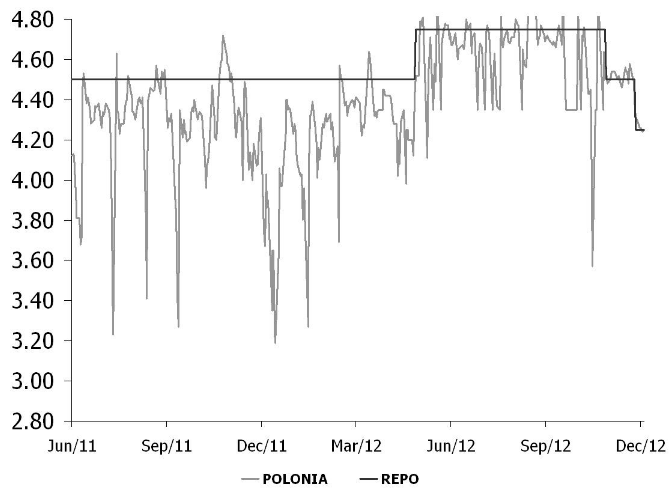
Liquidity risk aversion is growing Shortest rates should head south as we are approaching the end of the year and liquidity risk aversion is growing. Today's OMO supports our view since the intake was 3.5 billion pln lower then the supply (111 bln pln vs 114.5 bln pln).

Nothing to be bearish about in the nearest future CPI bit lower then consensus (2.8 vs 2.9%) and the rest of this month's figures should also support the bulls. Moreover, signals from the MPC indicate much softer approach than we used to. There are expectations for another 100 bps cut in the curve as of now, but we can not exclude further drop. Therefore, if anyone thinks of the payers we suggest waiting for at least one more 25 bps cut being built in the curve.







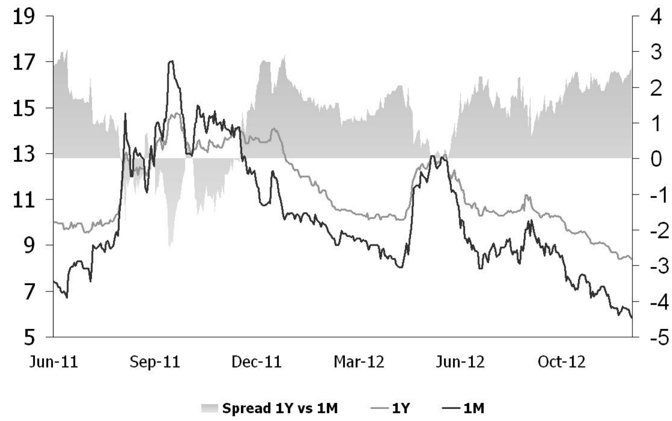


Forex

Range is intact The prospect of future rate cuts was not enough to weaken the Zloty substantially. With better global environment, the EUR/PLN rate (the main indicator of PLN strength/weakness) moved from 4.1360 (high of the week) to 4.0820 low, only to stabilize in the middle of the range, at roughly 4.0950. We don't expect much into the Xmass and the New year, liquidity is set to get worse and worse.

Tic lower The EUR/PLN volatility curve is only a tic lower from last week's close. EUR/PLN 1 month ATM is now 5.8% mid versus last week 6.0% mid, the 1 year is now 8.4% mid only 0.1% lower from last week. The biggest drop was in the currency spread (difference between USD/PLN and EUR/PLN) - roughly 0.35%, please note that this C/S is now quite steep 1month 3.75% and 1 year 6%. It is an exceptionally high time spread as usually it was close to being flat. The skew was slightly better-offered.

EURPLN volatility



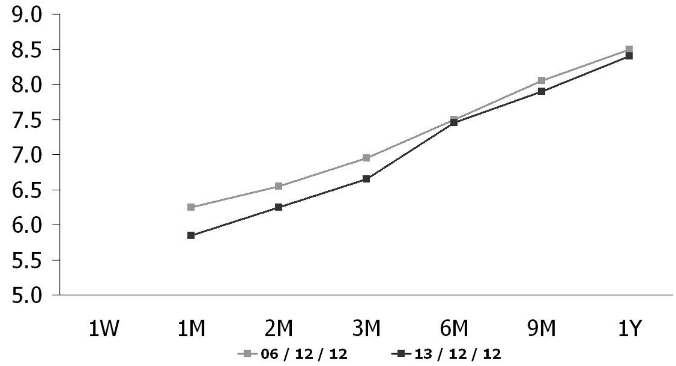
Short-term forecasts.

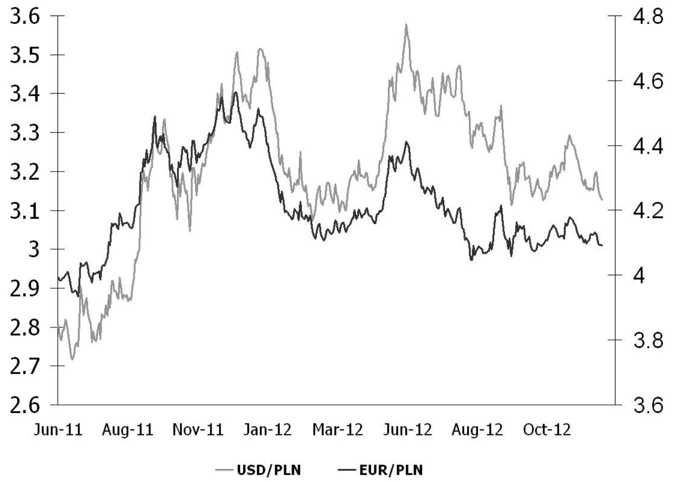
Main supports and resistances
EUR/PLN: 4.0800 / 4.1500
USD/PLN: 3.1500 / 3.2500

Spot. Play the range approach is still intact. We would sell EUR/PLN in the 4.14/4.16 region with stop above 4.1750 and hopes for a dive below 4.10 again. Or alternatively buy EUR/PLN at 4.07/4.09 level with stop bellow 4.0550 and eyes on 4.1250+.

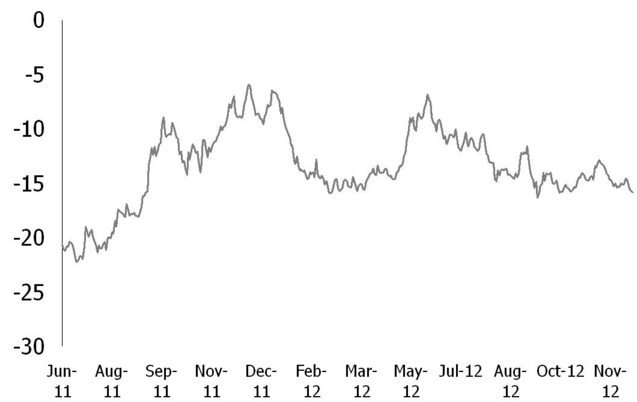
Derivatives. Unchanged from the last week. The XXX/PLN vols are back at theirs post/ Lehman lows, but the realized volatility is not really encouraging buyers. We think we should stay sidelined for the time being, the picture is blurred and the end of the year is so close, profit protection is a obvious strategy.

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
12/7/2012	4.05	4.35	3.93	6.49	3.75	6.59	4.12	3.65	3.18	3.08	3.12	3.22
12/10/2012	3.98	4.33	3.83	4.19	3.70	4.16	4.00	3.53	3.09	3.00	3.01	3.13
12/11/2012	3.98	4.32	3.86	4.17	3.75	4.14	4.04	3.56	3.14	3.06	3.07	3.18
12/12/2012	3.96	4.29	3.85	4.14	3.72	4.11	3.98	3.51	3.13	3.04	3.08	3.15
12/13/2012	3.93	4.26	3.73	4.12	3.64	4.09	3.98	3.55	3.16	3.07	3.13	3.15

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
12/7/2012	6.590	4.813	3.498	3.316	3.496	3.434	3.688	3.947
12/10/2012	4.160	4.813	3.435	3.224	3.415	3.328	3.585	3.867
12/11/2012	4.140	4.813	3.445	3.270	3.433	3.334	3.600	3.879
12/12/2012	4.110	4.813	3.438	3.269	3.410	3.327	3.595	3.879
12/13/2012	4.090	4.813	3.455	3.273	3.450	3.380	3.620	3.913

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
12/7/2012	6.20	6.85	7.55	8.55	8.55	3.20	0.73
12/10/2012	6.20	6.85	7.55	8.55	8.55	3.20	0.73
12/11/2012	6.00	6.75	7.50	8.45	8.45	3.19	0.73
12/12/2012	5.85	6.65	7.45	8.40	8.40	3.19	0.72
12/13/2012	5.85	6.65	7.45	8.40	8.40	3.19	0.72

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
12/7/2012	4.1332	3.1930	3.4166	3.8786	1.4587	0.1638
12/10/2012	4.1250	3.1978	3.4193	3.8884	1.4544	0.1638
12/11/2012	4.1025	3.1645	3.3870	3.8368	1.4526	0.1624
12/12/2012	4.0937	3.1459	3.3775	3.7975	1.4488	0.1621
12/13/2012	4.0927	3.1333	3.3834	3.7591	1.4442	0.1617

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