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

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@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

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Because of holiday season, this is a two-week edition of our Polish Weekly Review

Comment on the upcoming data and forecasts

Not much to watch out for in the next two weeks. On the last day of the year, the National Bank of Poland will publish its latest figure on inflation expectations (usually lags behind actual inflation). The year 2013 starts with the newest release of PMI index. We expect it to decline again, in line with recent developments in the real sphere.

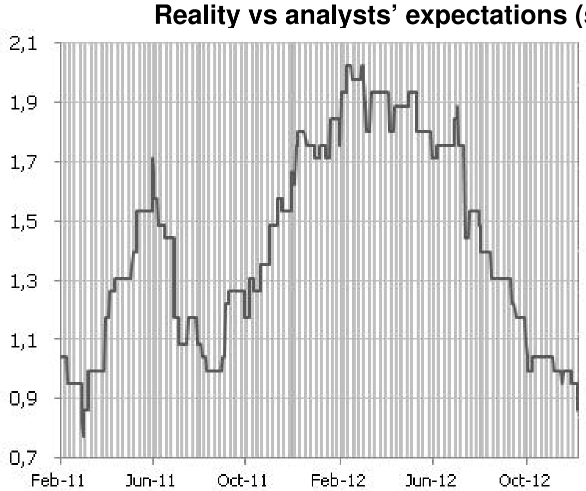
Polish data to watch: December 24th to January 4th

Publication	Date	Period	BRE	Consensus	Prior
NBP Inflation Expectations (%)	31.12	Dec		3.2	3.6
PMI (pts)	02.01	Dec			48.2

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
Recorded a significant drop as retail sales growth in November turned out to be significantly lower than expected. Despite the barrage of data, no other surprises. Another chance for the index to resume its downtrend next year, in mid January.

* 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

- Despite weaker economy and lower rates usual cyclical pattern for EURPLN set to be distorted by more balanced fiscal policy (Poland should exit deficit procedure in 2013) and accompanying lower current account deficit. Zloty is set to strenghten on portfolio capital inflows as well.
- Despite recent rally there is still room for lower rates in the short (much lower inflation, monetary easing, carry trades) and the long end (yield pickup, focus shift towards local currency bonds, no signs of any credit risk rise in the next weeks, if not months and... most likely Polish investors being stopped in). As the ongoing C/A rebalancing is rating positive, the process should provide additional support for Polish bonds.
- POLGB vs. German bunds spreads set to compress towards pre Lehman levels in the months to come. As more DM funds are pushed for more diversification and are faced with lower high grade issuances, compression in intra euro spreads should not pose a threat to Polish bonds.
- As global recovery continues and core yields rise accordingly in H2 2013 Polish yields may adjust as well. Polish bond yields should still remain low by historical standards, though.
- Volatility on both FX and FI 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	1.7
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	13.3	14.2
Repo rate (end of period %)	5.00	3.50	3.50	4.50	4.25	3.25

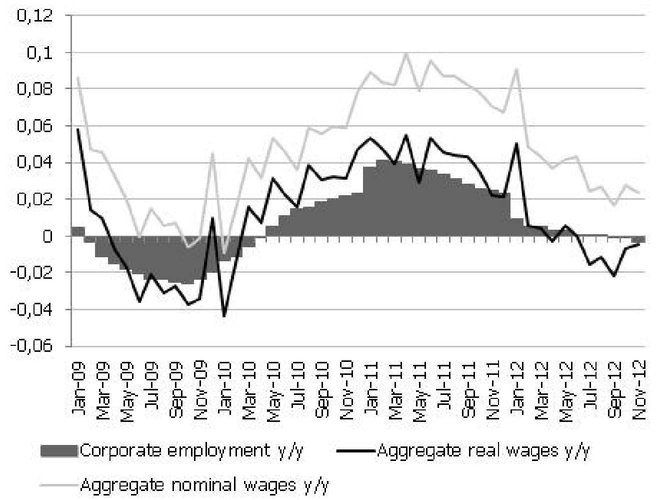
	2012 Q1	2012 Q2	2012 Q3	2012 Q4 F	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.6	2.3	1.4	0.7	-0.7	-0.2	0.9	1.9
Individual consumption y/y (%)	1.7	1.2	0.1	-0.2	0.2	0.5	1.0	1.5
Public Consumption y/y (%)	-0.8	0.5	0.2	0.0	1.0	1.0	1.0	1.0
Investment y/y (%)	6.0	1.3	-1.5	-4.0	-6.0	-5.0	-5.0	-3.0
Inflation rate (% average)	3.9	4.0	3.9	2.9	2.0	1.6	1.5	1.8
Unemployment rate (% eop)	13.3	12.4	12.4	13.3	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	4.05	3.65	3.15	3.15	3.15
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.15	3.00	3.00	3.10	3.10
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.70	3.50	3.50	3.70	3.80
EUR/PLN (eop)	4.15	4.22	4.12	4.05	4.10	4.10	4.00	3.90
USD/PLN (eop)	3.11	3.35	3.20	3.16	3.08	3.04	3.08	3.00

F - forecast

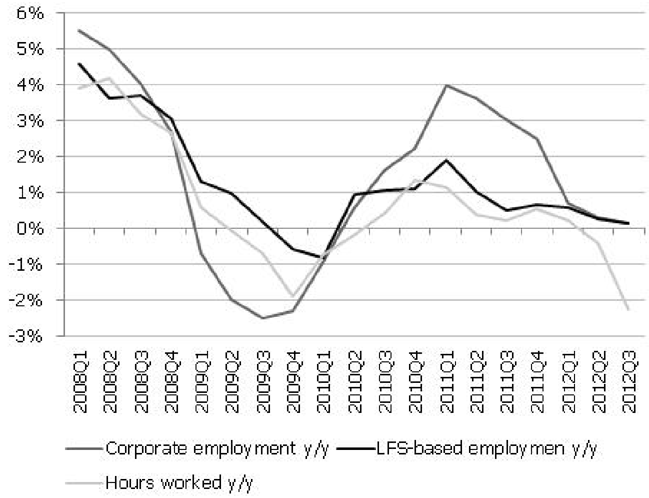
Economics

Wages in falling trend, negative employment growth indicates that the bulk of deterioration in the labor market is in the pipeline

Wages in the enterprise sector grew by 2.7% y/y in November (down from 2.9% in October). We think that this decline more or less reflects the difference in the number of working days. There are really no symptoms that the labor market is bottoming out. Even more so since employment growth amounted to -0.3% in November, and the number of laid-off workers amounted to 13k, the new record in this phase of the cycle.

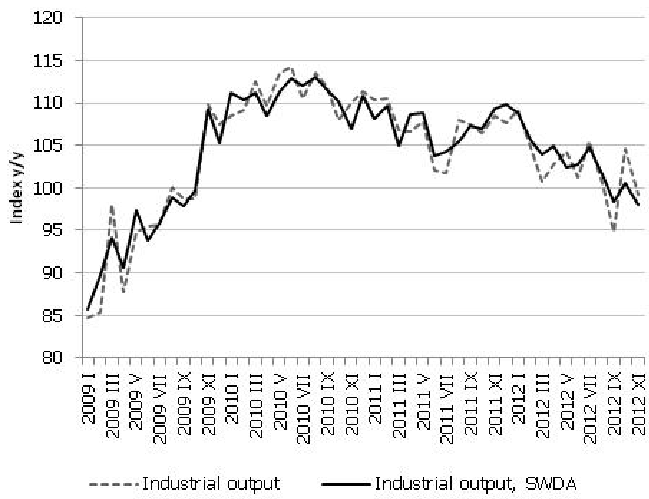


In our recent pieces on the labor market we encouraged you, our readers, to stay patient and believe in well-established economic relations. Labor market usually lags economic activity by 2 quarters. It is high time then to see the deterioration. We are well aware that somehow the relation between economic activity and employment has been recently softened due to the introduction of flexible working hours in 2009 (see the graph to see how the numbers of hours worked has fallen like a stone whereas employment growth is, so far, rock solid). We think that this new paradigm on the labor market may cushion only some minor cyclical fluctuations in aggregate demand. However, this time firms have been getting closer and closer to the wall and they are set to be forced to start cutting employment more aggressively soon. Another blow to domestic demand may come on top of fading statistical drivers of Polish growth (net exports, change of inventories), thereby shallow recession in H1 2013 is still in the cards.

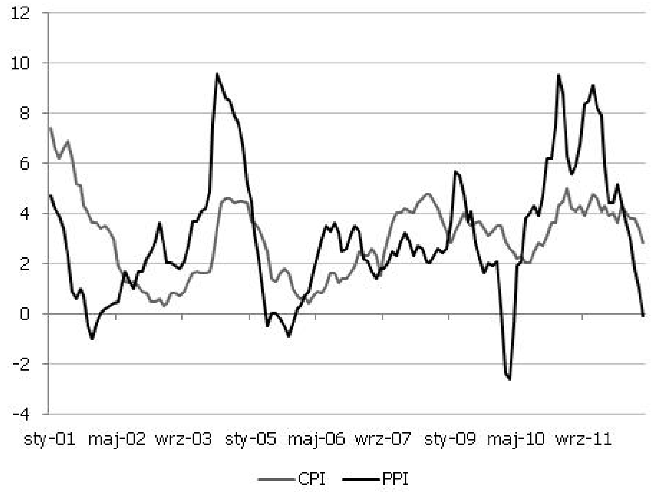


Recession at the gates. Annual drop in producer prices

Industrial output went down by 0.8% y/y in November. It is worth to note that output recorded a drop regardless of a positive difference in working days. In seasonally adjusted terms industrial output was down by 1.9% over the same period of previous year. As for the composition, under-water sections were those export- and infrastructure-oriented.



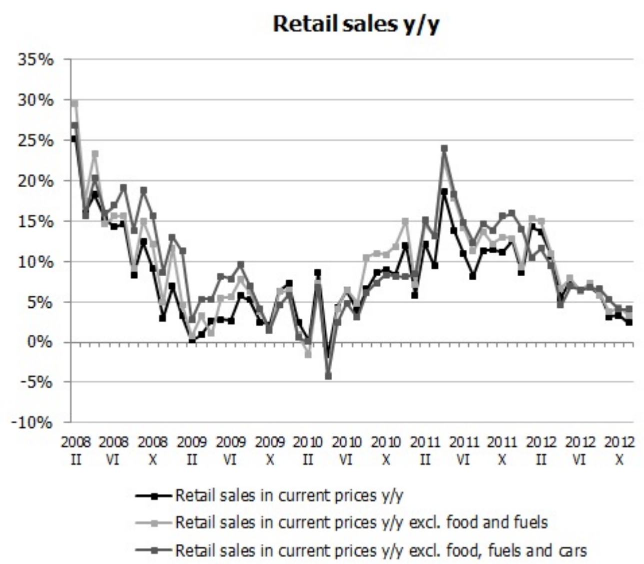
December is likely to bring another deterioration in output as the annual difference in working days turn negative from +1 to -2. Therefore it is not unlikely that industrial output growth may come close to -10% y/y. Q4 GDP is set to be below 1% y/y and turn negative at the start of 2013.



Poor activity in the real sphere is corroborated by the pricing behavior of enterprises. Producer prices in November turned negative (-0.1% y/y), what was possible on the basis of a slight monthly drop in manufacturing (and larger in mining) amid significant base effect from November 2011. We think that annual drops in producer prices may last for several months. At the same time the slack in the economy is set to limit the average monthly growth of prices through the whole 2013. Our technical indicator for future CPI inflation confirms we are deep into deflationary territory (see the graph).

Retail sales growth even lower and likely to be negative in December

Retail sales grew by 2.4% in annual terms in November (vis-a-vis +3,3% in October). Positive working day effects are still present in the data, downtrend is thus continued. Weakening of retail sales is visible in most categories - the only surprise came out in the ”other” category. Retail sales in core categories (excluding food, fuel and cars) remains in a clear downtrend.



Latest figures confirm the negative trend and even though there has been no dramatic collapse in consumer purchases, there are no reasons to expect a reversal of the trend. This is in line with consumer confidence data also published today - despite marginal increases, consumer confidence indices are still at a historical lows. Today‘s figures are consistent with recent tendencies on the labor market (stagnation in employment, real wage growth around zero). This suggests that larger declines in retail sales dynamics will happen as soon as the labor market substantially deteriorates.

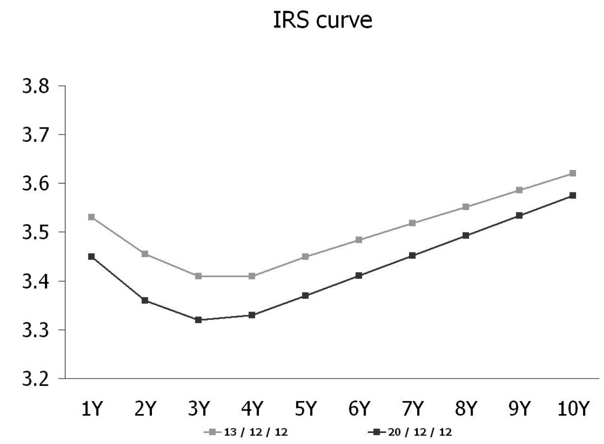
Working day effects are bound to depress retail sales in December (-2 days y/y) by as much as 2-3 percentage points in annual terms. Published in late January, the December figure will support another rate cut in February. We would also like to point out that retail sales data is probably inflated by the growing share of large chain stores (at the expense of small shops). The real figure is likely to be even lower, as Eurostat data indicate.

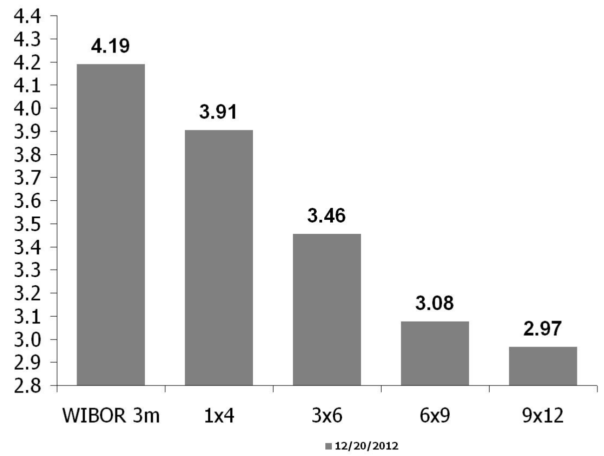
This week’s data confirm our view on the economy and the path of interest rates. We believe that monetary easing will be continued in the coming months - it is highly unlikely that the coming macro data will justify even one month of pause. Soon enough the MPC will have to ”explain itself” not only because of low economic growth and strong Zloty, but also due to inflation falling below the target (which will stimulate market expectations of further cuts). The whole easing cycle might end with the repo rate dropping to 3%.

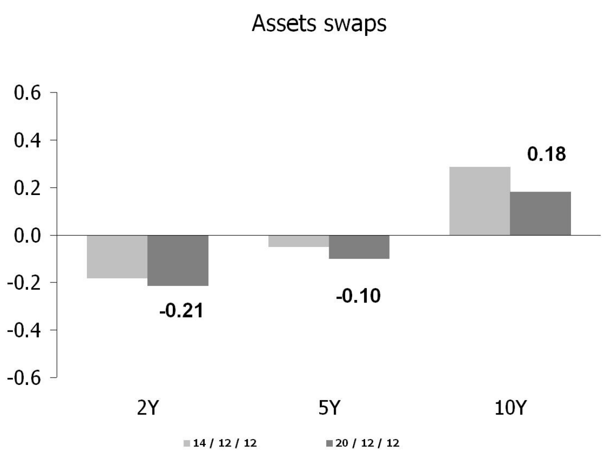
Fixed income

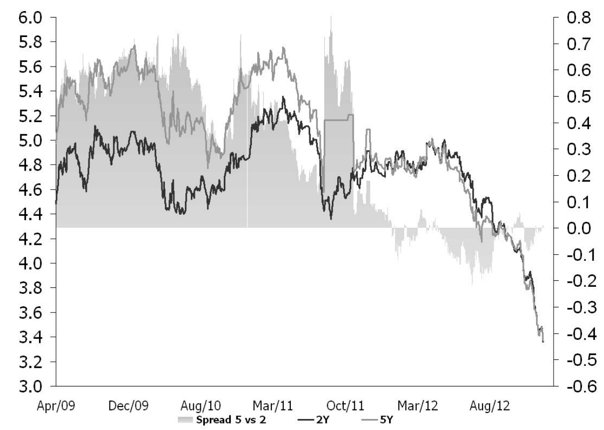
More records to come

The series of data from last week yet again confirmed that the slowdown is deeper than: 1) what market expects 2) what is assumed by the MPC. We had also minutes from the last MPC meeting with a surprising 150 bp motion (probably submitted by Bratkowski). Rates and bonds kept cruising for record lows, accompanied with a massive slide in the Wibor rate. Market is currently pricing a record low repo rates at 2.75% some time in 9 months time. It looks that the new year will likely maintain the trends both in the economy and in asset prices. We expect recession to still hit labor market, CPI to decelerate below lower band of NBP target and RPP to shift towards more aggressive easing starting from March inflation projection. In the meantime we will have some Eurozone declarations from politicians and it will be interesting to see if words will transform into some tangible plan. That would also have a significant impact on the shape of the curve and also bond prices. We feel quite confident that we haven't seen the lows in bond prices yet, especially in the belly of the curve, we are also quite confident that the MPC will have to embark onto more aggressive easing which will eventually steepen the yield curve. Long-end yields should be anchored by prospects of forming some plan of joining eurozone, even in a scenario when core market yields starts to rise. This is how we see first 3-6 months in the Polish market. Market has to adjust to the new bond levels. It looks that the beginning of the next year is a good opportunity to accept this fact.





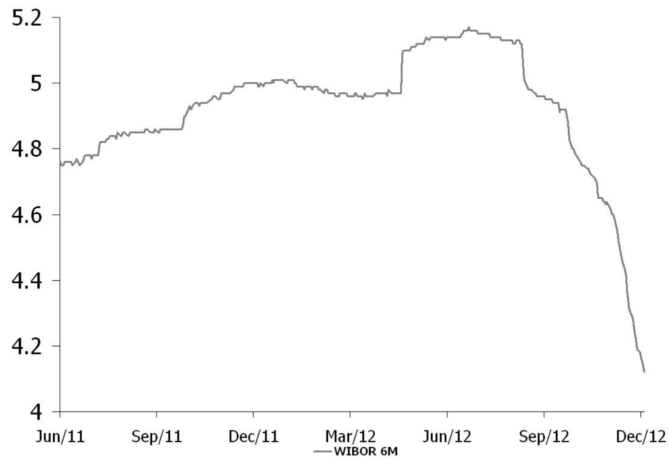


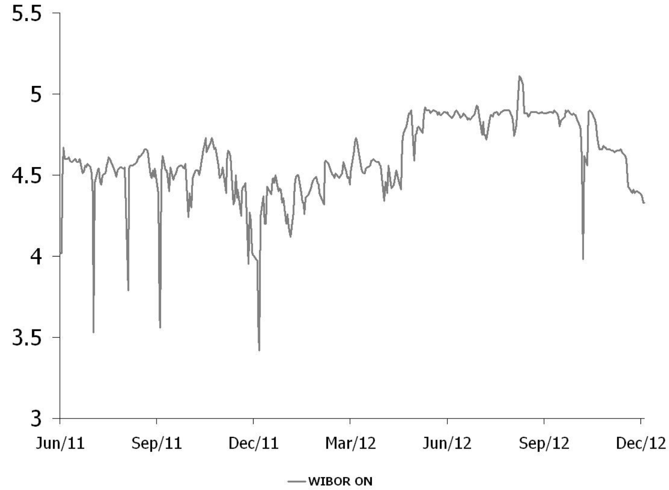


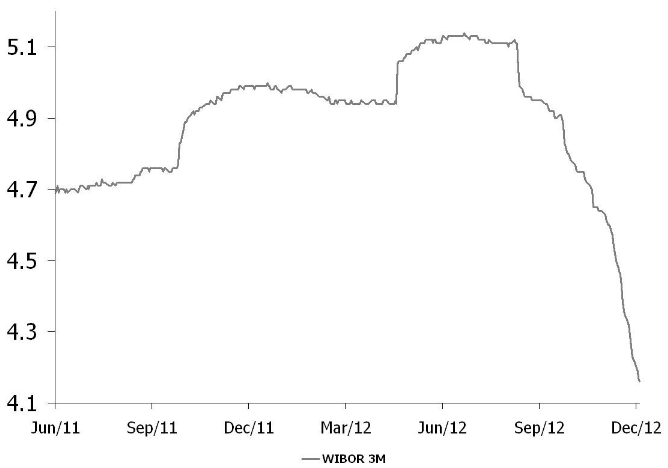
Money market

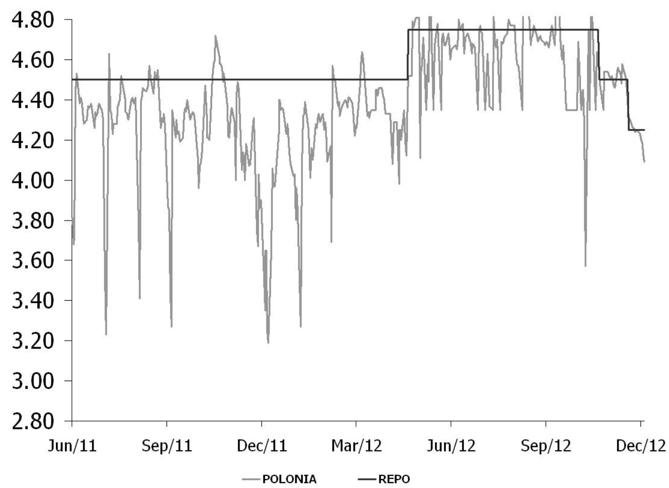
Liquidity in risk-averse mode Liquidity on the safe side which means that sufficient surplus of cash is being run - sufficient not to cause any major problems during the period of low activity. Therefore, the shortest rates should carry on drifting south. Today's OMO was significant enough to square the market (121 bln pln offer), however, banks in their risk-averse mode applied for 118 bln pln of money bills. That perfectly matches our view.

Figures strengthen rate cuts expectations This week's figures just strengthen bullish sentiments and rate cuts expectations. Not only industrial output but also retail sales give all the arguments for continuing the easing cycle. There is another 125 bps cut in the curve, and this is the wide consensus as of now. We expect the MPC to cut the rates in January by 25 bps.







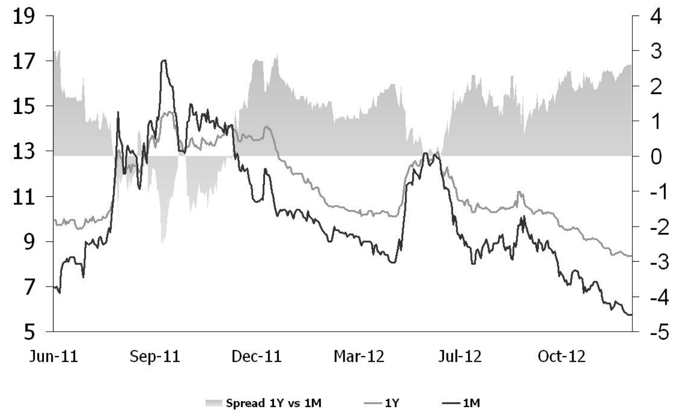


Forex

PLN stronger in range Złoty is getting stronger, as the end of year approaches. Weaker Polish data are being ignored by the market. We think we are still in the range, and the support zone at 4.05/4.07 is being currently tested. If we eventually crack that support, we would rather see it as the range moving lower to 4.00 - 4.10 from current 4.05/4.15. Better global environment, and future rate cuts / slowdown in Poland are simply offsetting itself and we expect the range to persist for the time being.

Unchanged The EUR/PLN volatility curve is virtually unchanged with frontend still slightly better-offered (1 month ATM mid 5.9%) and the rest of the curve with only cosmetic changes (3 month mid 6.6% and 1 year still 8.4%). The currency spread (difference between USD/PLN and EUR/PLN) was finally better bid after weeks of falling as USD/PLN was a little more entertaining thanks to EUR/USD volatility. The skew is unchanged from last week, and liquidity is evaporating from the market, as more and more banks/customers are "done for the year".

EURPLN volatility



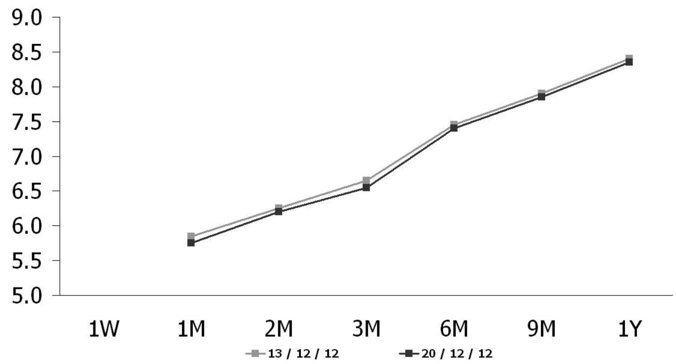
Short-term forecasts.

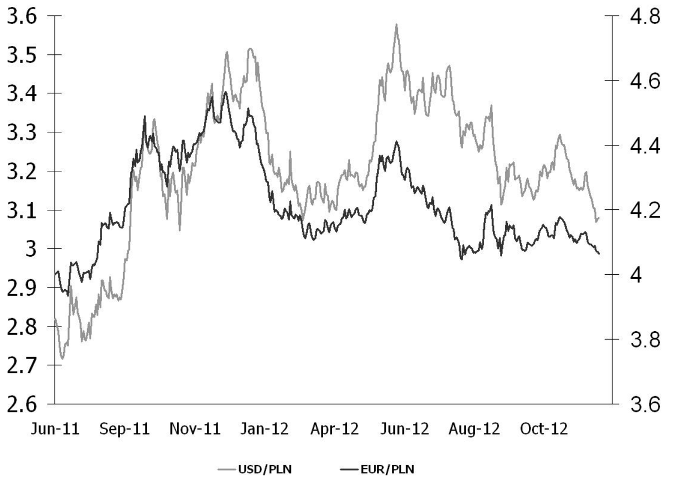
Main supports and resistances
EUR/PLN: 4.0800 / 4.1500
USD/PLN: 3.1500 / 3.2500

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 4.0500 and eyes on 4.1250+. The support zone is being on the fire right now, and if 4.05 gives way, the new 3.98/4.00 - 4.10/4.12 range will start to dominate.

Derivatives. 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
12/14/2012	3.90	4.23	3.71	6.49	3.63	6.59	3.96	3.53	3.15	3.08	3.06	3.18
12/17/2012	3.90	4.21	3.69	4.08	3.59	4.02	3.94	3.53	3.16	3.06	3.06	3.19
12/18/2012	3.93	4.20	3.88	4.06	3.74	4.00	3.93	3.52	3.16	3.08	3.08	3.20
12/19/2012	3.94	4.19	3.88	4.05	3.79	3.98	3.94	3.51	3.14	3.01	3.07	3.15
12/20/2012	3.96	4.17	3.79	4.04	3.64	3.95	3.91	3.46	3.08	2.97	3.01	3.12

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
12/14/2012	6.590	4.813	3.465	3.285	3.450	3.400	3.630	3.915
12/17/2012	4.020	4.813	3.483	3.311	3.480	3.398	3.645	3.904
12/18/2012	4.000	4.813	3.460	3.317	3.460	3.417	3.650	3.910
12/19/2012	3.980	4.813	3.415	3.275	3.420	3.351	3.630	3.873
12/20/2012	3.950	4.813	3.360	3.148	3.370	3.270	3.575	3.755

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
12/14/2012	5.75	6.55	7.40	8.35	8.35	3.19	0.72
12/17/2012	5.75	6.55	7.40	8.35	8.35	3.19	0.72
12/18/2012	5.75	6.55	7.40	8.35	8.35	3.19	0.72
12/19/2012	5.75	6.55	7.40	8.35	8.35	3.19	0.72
12/20/2012	5.75	6.55	7.40	8.35	8.35	3.19	0.73

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
12/14/2012	4.0912	3.1271	3.3847	3.7306	1.4417	0.1621
12/17/2012	4.0839	3.1035	3.3811	3.7034	1.4364	0.1621
12/18/2012	4.0900	3.1044	3.3860	3.6990	1.4195	0.1622
12/19/2012	4.0730	3.0690	3.3703	3.6394	1.4166	0.1618
12/20/2012	4.0715	3.0769	3.3716	3.6642	1.4232	0.1615

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