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Comment on the upcoming data and forecasts

All eyes on the MPC with renewed hopes for a larger-than-usual rate cut. However, positive surprises are unlikely in our view. Market expectations for a 50 bps cut might be exaggerated, especially after it was revealed that a failed motion for a 150 bp cut was put during the last meeting. Despite poor economic data and market expectations for a 50 bp cut, the Council will probably cut interest rates by 25 bps, again. This is in line with current monetary policy stance and the broader consensus within the Council (one that includes Mr Hausner and Mr Rzońca). Larger cuts are more likely after the next inflation projection (March).

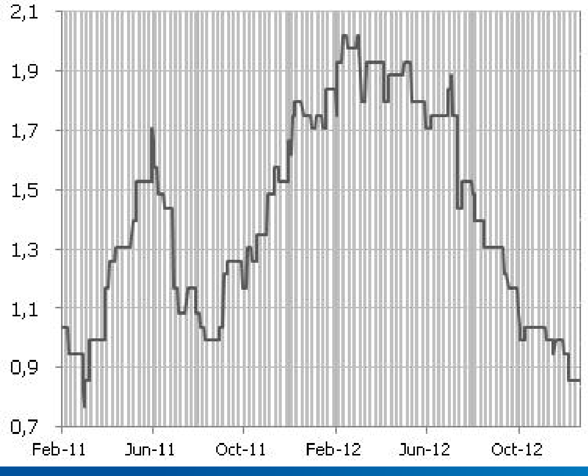
Polish data to watch: December 24th to January 4th

Publication	Date	Period	BRE	Consensus	Prior
NBP Reference Rate Decision	09.01	Jan	4.0	4.0	4.3

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 OK0715	1/23/2012	5000	3.856	10/23/2012
5Y T-bond PS0418	1/23/2012	4000	3.900	11/8/2012
10Y T-bond DS1023	-	4000	3.847	1/3/2013
20Y T-bond WS0429	-	1000	3.896	1/7/2013

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



Comment
Unchanged (the rise in PMI well within its natural range of variability) and bound to remain stable next week (no data releases).

* 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 along with further deterioration in high frequency data).
- We expect Polish economy to enter recession in H1 2013 (negative GDP growth in y/y terms). External developments (meager growth in Germany, zero growth in euro zone) are not dynamic enough to offset deceleration in domestic demand. Consumption growth close to zero (zero savings rate, deleveraging urgently needed), negative investment growth rate (public investment as an original damper to growth, private investment to dip into negative territory soon on weak demand prospects), restrictive fiscal policy.
- We find it hard so far to pin down factors facilitating a rebound in H2 2013. A faster re-acceleration of the euro zone economy seems to be the most obvious one as we leave government programs aside (given time lags in their implementation). However, given the scale of slack in investment and consumption any rebound generated this way cannot be a meaningful one. Poland has entered a period of weaker growth.
- 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).
- 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. The possibility for significant undershooting of inflation target in 2013 is high.
- Monetary easing cycle started already in November. MPC is backward-looking so we expect more than 150bps interest rate cuts, as soon as weaker economy leaves its print on inflation. Rising real interest rates make further interest cuts look easier, so does relatively strong zloty.

Financial markets

- We are quite surprised by the scale of recent sell-off on Polish bonds - they are clearly more sensitive to core markets developments and Polish market is less liquid than we thought. It is also more clear that global recovery (or monetary stimulus withdrawal) and rising core yields rise may adversely affect Polish bonds as well.
- Fundamental reasons for lower yields in Poland (much lower inflation, monetary easing, carry trades, yield pickup, credit risk well contained) stay intact. As the ongoing C/A rebalancing may be rating positive, the process should provide additional support for Polish bonds.
- We still expect fundamental reasons to prevail and POLGB's to stay at historically low levels. Core markets may have gone too far in expecting a much faster halt to Fed's more hawkish guidance. DM funds are pushed for more diversification and are faced with lower high grade issuances. Therefore compression in intra euro spreads should not pose a threat to Polish bonds.
- Cyclical behavior of the Polish zloty far weaker than in 2008-2011 as current account has been narrowing and euro zone disintegration risks were put aside with ECB put. Hence we expect only slight weakening of the zloty with 4.22/25 (technical analysis) acting as a hard resistance.
- 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	3.20	3.20	3.20
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.15	3.10	3.10	3.20	3.30
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.70	3.70	3.70	3.90	4.00
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

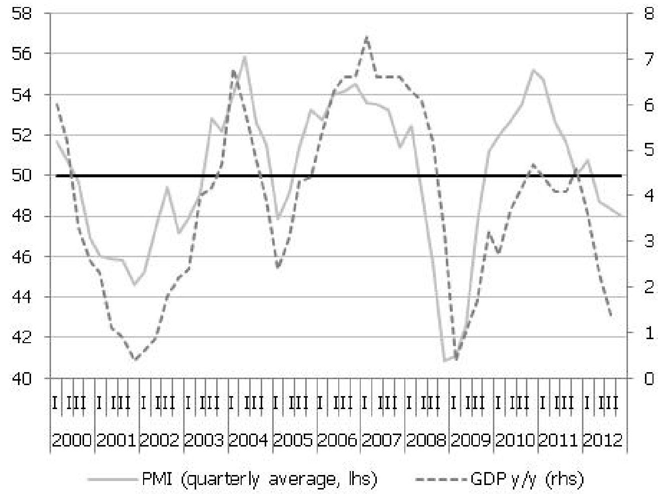
Economics

PMI higher but well below levels consistent with unchanged GDP dynamics (51 pts)

The Purchasing Managers' Index amounted to 48.5 pts in December as compared to 48.2 pts in November, almost at the level forecast by us. Given the fact that business tendency indicators published by the Central Statistical Office (output, new orders, employment) have come out worse last month, the rebound in the index must be ascribed to a positive surprise in the German IFO index (but not PMI which remain increasingly disconnected with its Polish counterpart - see the graph below). It is worth noting that there has also been a divergence within the region - PMI indices in Czech Republic and Hungary fell by a few points.

The press release indicates that almost all components of PMI fell, albeit at a lower rate (especially the output-related subindex grew from 48.1 to 48.3 pts) - thus the increase in the overall index. The connection between PMI and data releases from the real economy has been weak recently (i.e. correlation is falling). If we attempted to repeat this reasoning regardless, we would be forced to expect a roughly unchanged seasonally adjusted annual growth rate in industrial output. This does not contradict our sharply negative forecast of the headline growth rate since the difference in the number of working days has been of tantamount importance in December. Moreover, the arrangement of public holidays has likely depressed the actual working time in industry more significantly than the simple count of working days would suggest. Finally, the latest PMI release indicates that a slight positive surprise in December employment figures can be expected (our forecast: -0.3%, consensus: -0.4%). We've already had such impression upon inspecting detailed monthly employment data - certain seasonal anomalies occuring in November should have pushed employment growth slightly higher last month.

Last but not least, we present a comparison between PMI and GDP growth (see the graph below). While in the previous slowdowns quarterly PMI average has been a decent approximation of monotonically decreasing GDP growth rates, this connection has been somewhat blurred recently (turning points did not coincide, GDP deceleration has become delayed vis-a-vis PMI).

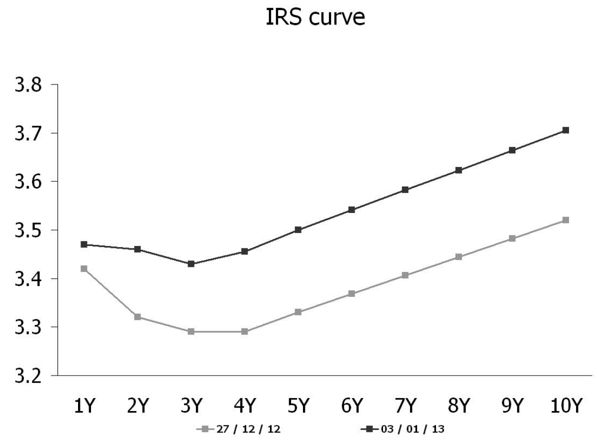


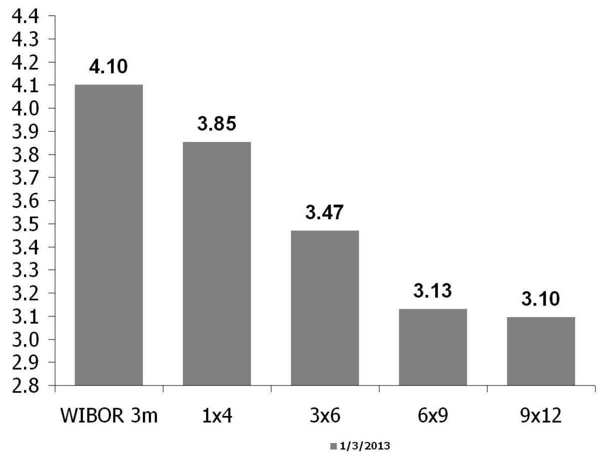
Simple regressions (but with statistically significant parameters) using historical data (2000-2012) suggest that GDP dynamics declines when PMI falls below 51 pts. Current levels of the index thus still indicate a decelerating path for GDP. Similar regressions also indicate that GDP declines on annual basis when PMI falls below 41 pts. The recent divergence between PMI and GDP growth means, however, that statements about recession not occuring in the first half of 2013 are to be doubted. Given the fact that business climate has stabilized in Germany, such a sharp drop in Polish PMI is highly unlikely. The last graph alone indicates that structural changes have occured in the Polish economy (their nature we are unsure of) and that historical correlations could be no longer valid. To wrap up, if current PMI levels accompany a very weak economy, the recession-consistent threshold has moved upwards from the aforementioned 41 pts.

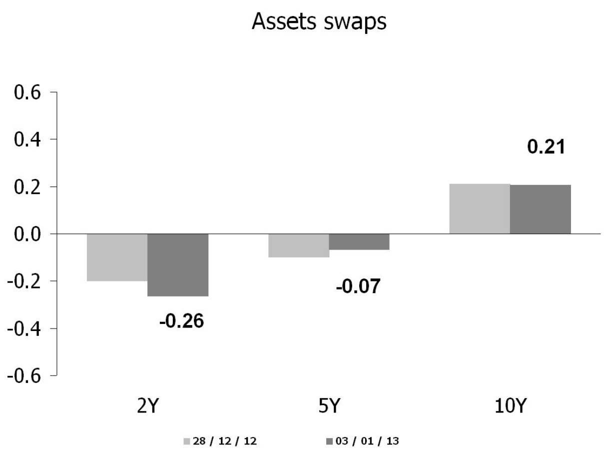
Fixed income

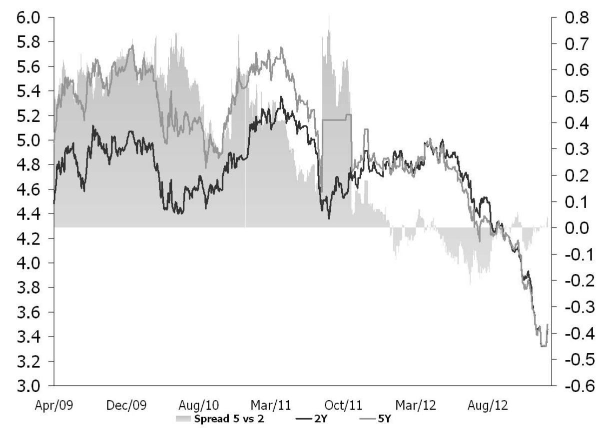
Correction

New Year started with significant correction on bonds and rates. As core markets sold off, PolGBs followed the move and rates were pushed up by 15-25bp, with long end losing the most. Additional supply coming from quite a significant bond auction only increased the sell-off dynamics amid low liquidity. Considering the scale of recent streghtening and the levels, correction was definitely due. However, considering that the move has been caused by external factors, it's quite difficult to assess potential scope of further weakening. Domestically we think that upcoming macro data should be rates positive - CPI will continue falling, industrial output will fall into negative territory, the MPC will cut rates again next week and will most likely signal further easing to come. All in all we consider this move solely a correction and not a change of trend and should it continue further we'd be looking for levels to enter long positions ahead of this month's data releases.





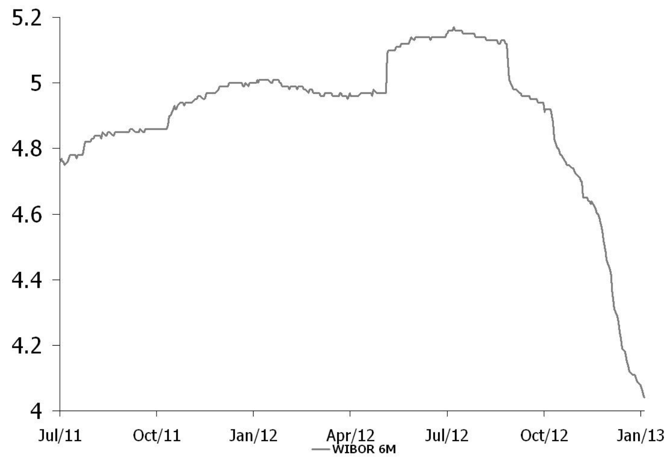


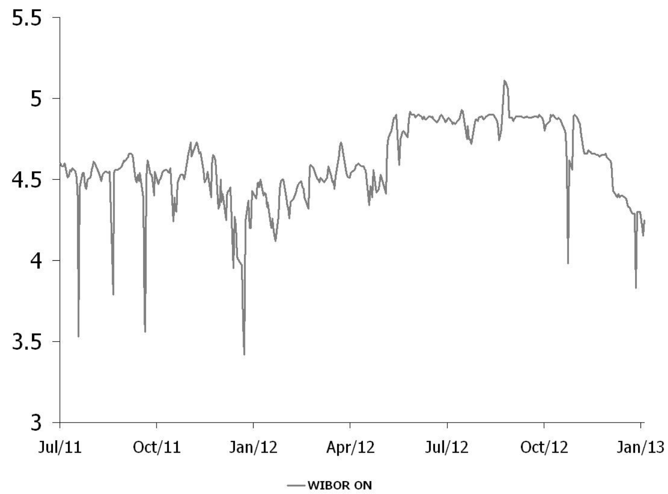


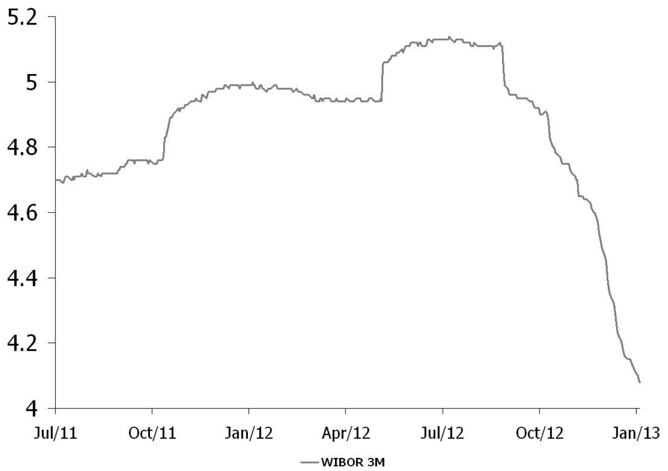
Money market

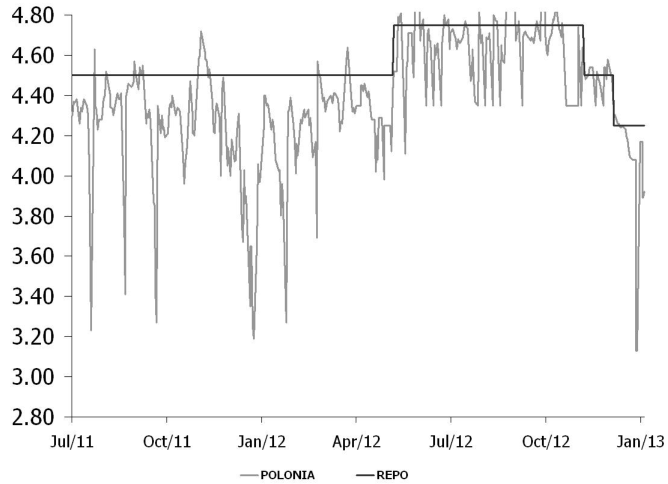
Volatile start of the year Just from the beginning of the year we had a big move on interest rates. Front end rates rose around 15-20 BP. This can be viewed as a denial of Xmas rally. Market has already excluded any chance for 50 bp cut in January after this move. We don't agree with that so receiving 2 and 3 month OIS could be quite profitable if a 50BP cut occurs.

Cost of carry As everybody expected, last weeks of the year where quite cheap. Historical 1 month polonia vs reference rate spread widened from 0 to 16 bp, and 3 month from 5bp to 10 bp. Since new year has already started, the spread should tighten again.







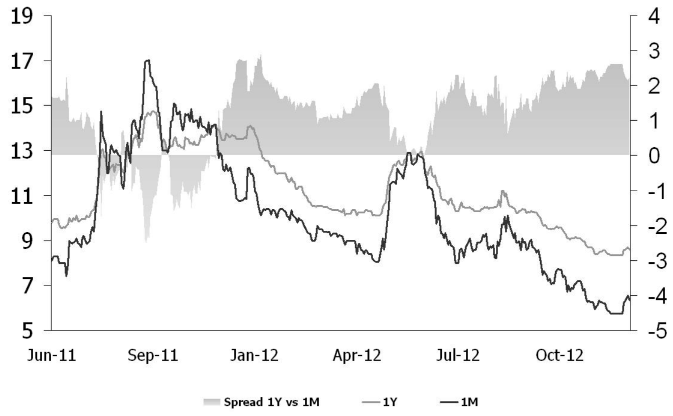


Forex

Higher in range The new year started well for emerging markets. EUR/PLN was traded very stable in the vicinity of 4.07 until Thursday evening, when FOMC minutes revealed that several members "thought it would probably be appropriate to slow or to stop asset purchases well before the end of 2013". It was the catalyst for pushing the CEE currencies to fresh highs. EUR/PLN has broken the top side of its recent range at 4.10 and exploded almost to 4.13 area. Despite some risk-off mood today, we believe that 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.

Higher The losses of PLN, inevitably lead into the vol uptic. The frontend was better bid: EUR/PLN 1 month ATM is now 6.7% mid versus last week 6.3% mid. The 1 year is now 8.7% mid only 0.1% higher from the last week. The skew and 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.

EURPLN volatility



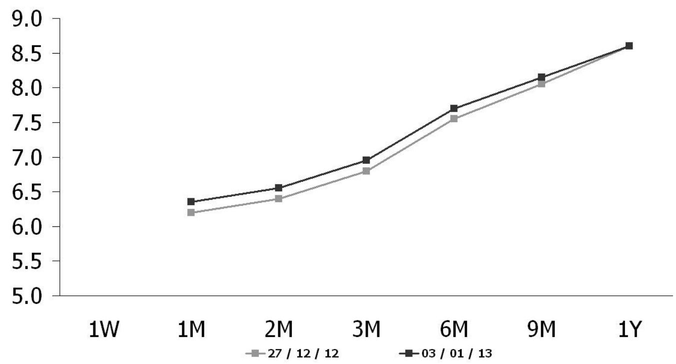
Short-term forecasts.

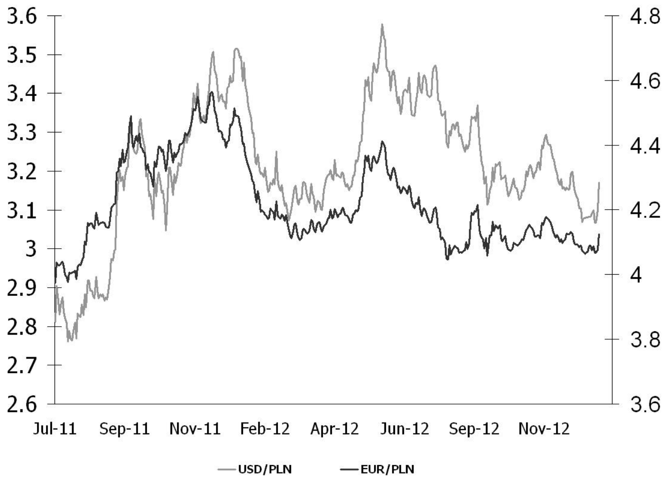
Main supports and resistances
EUR/PLN: 4.0800 / 4.1500
USD/PLN: 3.0600 / 3.2500

Spot The 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 4.05 and eyes on 4.1250+.

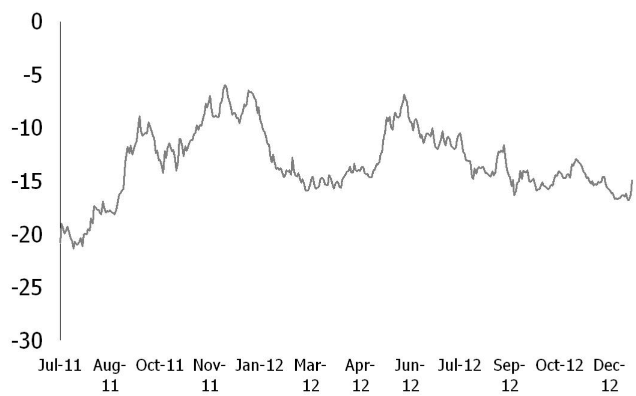
Derivatives The XXX/PLN vols are back at theirs post-Lehman lows, but the realized volatility is not really encouraging buyers. We think we should stay sidelined for the time being, the picture is blurred and the end of the year is so close, profit protection is a obvious strategy.

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
12/27/2012	3.98	4.14	3.79	4.00	3.66	3.90	3.85	3.45	3.08	2.97	2.99	3.09
12/28/2012	3.98	4.13	3.83	6.49	3.62	6.59	3.83	3.44	3.07	2.97	2.99	3.13
12/31/2012	3.86	4.11	3.77	3.98	3.64	3.88	3.84	3.43	3.07	2.95	2.97	3.11
1/2/2013	3.98	4.10	3.77	3.96	3.63	3.86	3.87	3.46	3.10	3.03	3.07	3.12
1/3/2013	3.98	4.09	3.85	3.95	3.60	3.85	3.85	3.47	3.13	3.10	3.15	3.16

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
12/27/2012	3.900	4.813	3.415	3.275	3.420	3.351	3.630	3.873
12/28/2012	6.590	4.813	3.360	3.148	3.370	3.270	3.575	3.755
12/31/2012	3.880	4.813	3.320	3.137	3.325	3.237	3.525	3.759
1/2/2013	3.860	4.813	3.320	3.137	3.325	3.237	3.525	3.759
1/3/2013	3.850	4.813	3.320	3.137	3.325	3.237	3.525	3.759

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
12/27/2012	6.20	6.80	7.55	8.60	8.60	3.21	0.72
12/28/2012	6.35	6.90	7.70	8.60	8.60	3.21	0.72
12/31/2012	6.45	7.00	7.75	8.65	8.65	3.22	0.72
1/2/2013	6.35	6.95	7.70	8.60	8.60	3.21	0.72
1/3/2013	6.35	6.95	7.70	8.60	8.60	3.21	0.72

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
12/27/2012	4.0899	3.0816	3.3839	3.5938	1.3933	0.1628
12/28/2012	4.0745	3.0893	3.3725	3.5935	1.3990	0.1626
12/31/2012	4.0882	3.0996	3.3868	3.6005	1.3977	0.1630
1/2/2013	4.0671	3.0660	3.3647	3.5205	1.3883	0.1616
1/3/2013	4.0770	3.1005	3.3717	3.5590	1.3999	0.1614

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