BRE BANK SA

POLISH WEEKLY REVIEW

January 18, 2013

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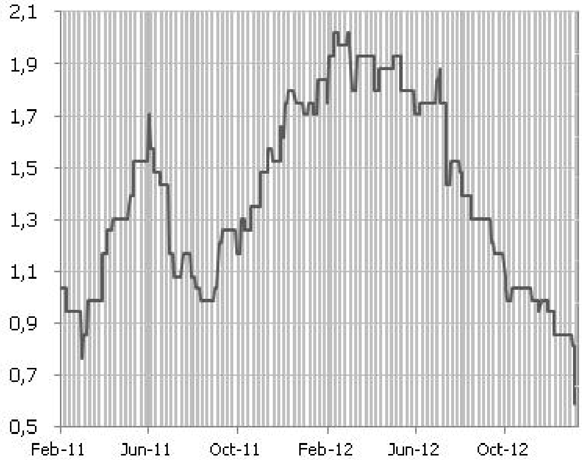
Polish data to watch: January 21st to January 25th

Publication	Date	Period	BRE	Consensus	Prior
NO RELEVANT DATA					

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Last yield (%)	Prev auction
52 Week T-bills	-	3600	3.560	1/9/2013
2Y T-bond OK0714	1/23/2013	5000	3.856	10/23/2012
5Y T-bond PS0418	1/23/2013	4000	3.900	11/8/2012
10Y T-bond DS1021	-	4000	3.847	1/7/2013
20Y T-bond WS0429	-	4000	3.896	1/7/2013

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



Comment
Index significantly lower after industrial output data (-10.6% y/y in 2012) and PPI disinflation (which amounted to -1,1% y/y). Polish economy steps towards recession (read more in economic section).

* 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 below 2.0% 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 rates to fall to 3.25%, as soon as weaker economy leaves its print on inflation. Rising real interest rates make further interest cuts look easier, so does strong zloty.

Financial markets

- 2013 most likely not a ”bond year”. Global ”rotation” of assets poses headwind for debt.
- Polish bonds clearly more sensitive to core markets developments. It is also more clear that global recovery (or monetary stimulus withdrawal) and rising core yields (ECB ruling out refi rate cuts, Fed discussing exit strategy) may adversely affect Polish bonds as well.
- Fundamental reasons for lower yields in Poland (much lower inflation and growth, monetary easing, carry trades, yield pickup, credit risk well contained) stay intact.
- We still expect POLGB's to stay at historically low levels. However, curve should steepen. DM funds are pushed for more diversification and are faced with lower high grade issuances. Therefore compression in intra euro spreads should not be critical for 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	1,65
Current account (%GDP)	-5,3	-1,6	-4,5	-4,9	-2,6	-2
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	1,8	1,5	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	4,11	3,65	3,30	3,30	3,30
2Y Polish bond yields (% eop)	4,62	4,60	4,05	3,14	3,20	3,10	3,20	3,30
10Y Polish bond yields (% eop)	5,50	5,15	4,69	3,74	3,80	3,80	4,00	4,20
EUR/PLN (eop)	4,15	4,22	4,12	4,08	4,20	4,15	4,10	4,00
USD/PLN (eop)	3,11	3,35	3,20	3,09	3,16	3,07	3,15	3,08

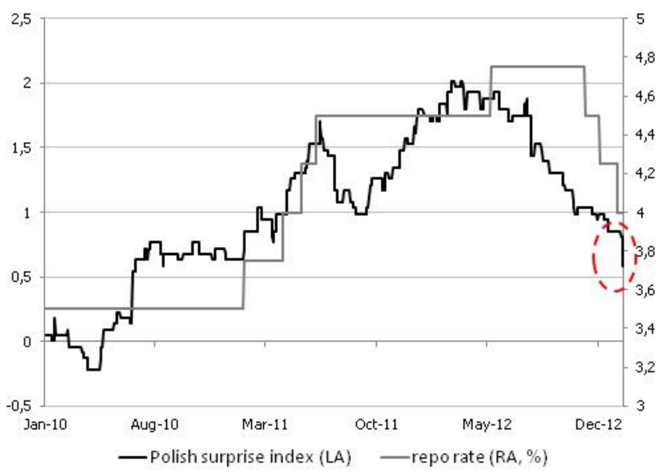
F - forecast

Economics

Another step towards recession

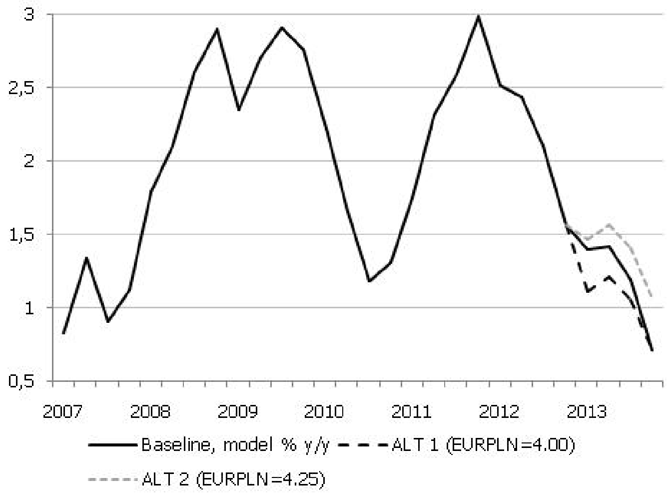
Not once had we written that economy would challenge us with our recession scenario as high frequency data may be pointing sideways. There were ups and downs, but now after some months we made a step towards recession, maybe even a leap. Today we learned that not only output data plunged, but also labor market probably embarked on a second phase of deterioration. Interestingly, the signals from the real sphere are now visibly correlated with nominal processes, namely with a steep fall of producer prices. It confirms that output gap is widening and the actual (or worse - even expected) fall in activity is gaining speed.

Speaking in monetary policy terms, the streak of recent data corroborates a rate cut in February. It is evident that MPC may have rushed with announcing a pause in the easing cycle. We expect that falling business activity and a series of consecutive downside surprises (see the graph) easing cycle is set to be continued until policy rate falls to 3.25% (we cannot exclude pauses in between). Last but not least, and not as silly as it seems at first sight, a realized fall of CPI inflation below NBP should encourages MPC members, regardless of outlook. And now let us turn to the details.

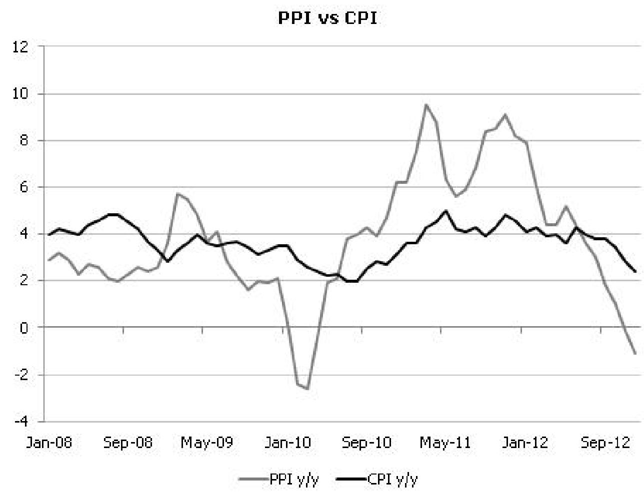


CPI Inflation (finally, a notch below NBP target). Inflation came out at 2.4% (below consensus of 2.5%) after 2.8% in December. Quick look at the composition reveals that there are only few rising categories on monthly basis, and they are seasonal. Headline inflation is set to fall to around 2% in Q1 on gas price cuts and thereafter to below 1.5% in H1.

It is no surprise then that core inflation went down to 1.4% y/y (1.7% previously). Our model based on lagged consumption and exchange rate (to be honest the lag is so substantial that the forecast can be prepared solely on the basis of the data that had been already published) suggests that core inflation is set to fall substantially below 1% in 2013 (even when PLN exchange rate devaluates to 4.25 in the whole 2013, ALT2 scenario).



Producer prices went down by 1.1% y/y. It translates into twice more pronounced drop on monthly basis (this includes, unfortunately, also our forecast). It is especially worth to note that it is not the first month when our econometric model based forecasts diverge from the actual reading. Since monthly forecast models from definition should not include any fundamental or cyclical explaining variables (the rationale is: those variables do not change so frequently) it highly possible errors are driven by yawning output gap. Prices reflect relative prices and they change when economy accelerates or decelerates. Therefore, recession time!

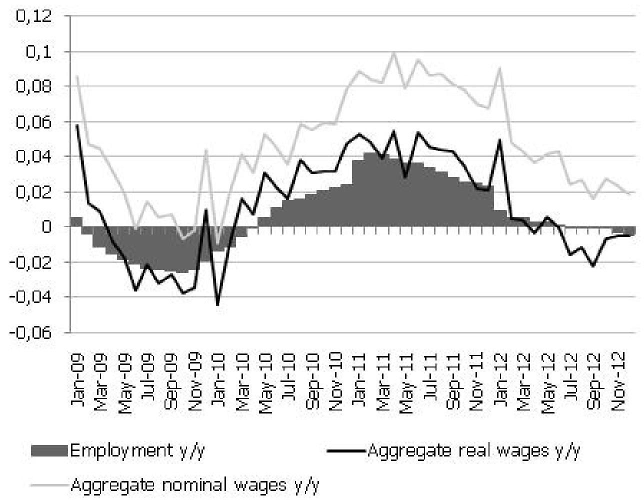


Industrial output was in December 10.6% lower than in the previous year (in November it dropped by 0.8% y/y). After eliminating seasonal factors, output growth reached -5.1% y/y. Such a decline was partly attributed to seemingly bigger than -2 working days difference (24th and 31st December should be also at least partially counted as holiday days) and partly reflects steepening of the downtrend observed in manufacturing data. Although some analysts find the latter not really consistent with PMI data, we stick to our assessment since previously useful correlation between industrial output and PMI has broken down.

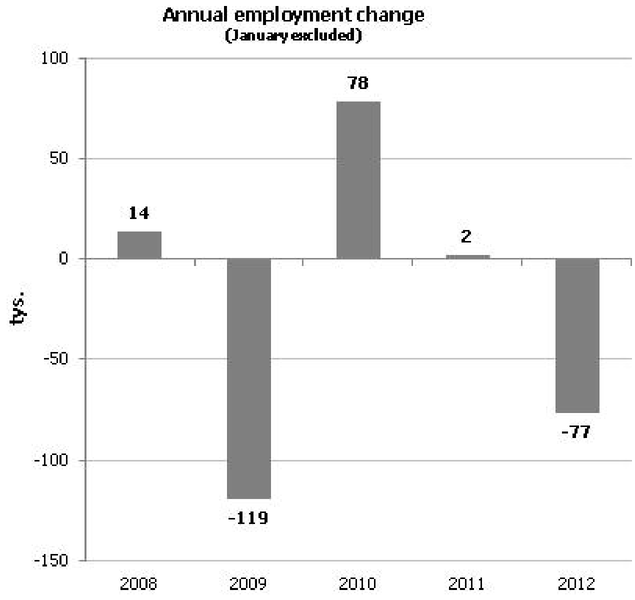
As compared to December 2011, a drop in industrial output was reported in 30 out of 34 industry divisions and their composition does not favor exporting sections - the highest drop was of non-metallic mineral products, which reminds us rather of construction sector, others may be connected with investment in machinery and equipment (and to some extent with exports). Industrial production doldrums should continue in the months to come. Annual growth rate may increase slightly on positive difference in working days (in January +1 y/y) though and to some extent with connection to more positive statistical base effects present from the beginning of 2012. It may be still too little to overcome the negative effect of weakness cast on output by factor markets (usually drop in employment is followed by weaker capital demand) and annual growth rate should remain below zero.

Construction output fell by 24.8% on annual basis. It is one of the deepest slumps in the history of this series. Obviously, such a dramatic decline is mostly a result of a very unfavorable alignment of working days but the structural component of the figure is bound to be significantly negative. The coming months will not bring a substantial upswing in the sector. Housing is still weak, as witnessed by the data on building permits and starts and support from public investment is not coming yet. We expect GDP growth to come near 0.5% y/y in Q4'2012 and drop in Q1'2013 on annual basis (statistical recession).

Labor market (second wave of deterioration has began). Corporate employment in December came out at -0.5% on a yearly basis, lower than analysts' consensus (-0.4%). Corporate wages grew by 2.4% on an annual basis (consensus: +2.1%, our forecast: +1.1%).



Today's data, combined with Tuesday's inflation release, mean that real wages remained unchanged from last year. It's the fifteenth consecutive month in which real wage growth oscillated around zero - the longest such period in the history of the series. Aggregate nominal wages grew by 1.9% and real aggregate wages dropped by 0.5% on annual basis, in both cases confirming negative trends observed in the previous months. The fall in inflation is no longer sufficient to keep real income of the population afloat.

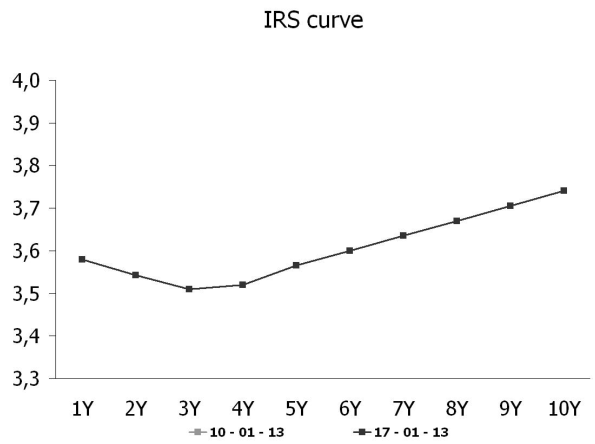


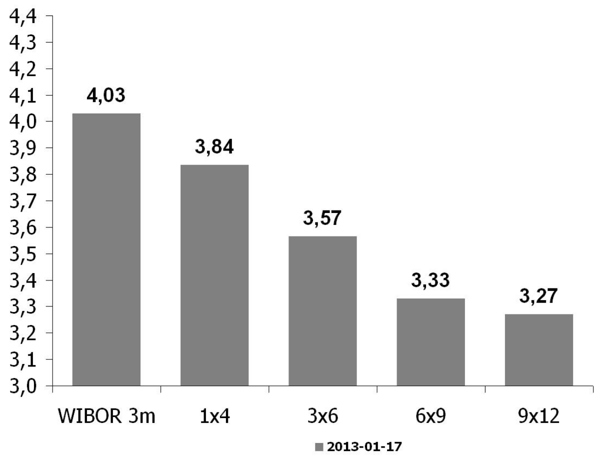
Today's data clearly point out that the "hibernation period" on the labor market has come to an end in the fourth quarter. In coming months the real economy will cut jobs at an increasing pace, following the already observed deterioration in business climate and in line with employers' expectations (see business tendency surveys carried out by GUS and NBP). This data release also paints a grim picture for the internal engine of the economy: a rebound in private consumption in the fourth quarter becomes even less likely.

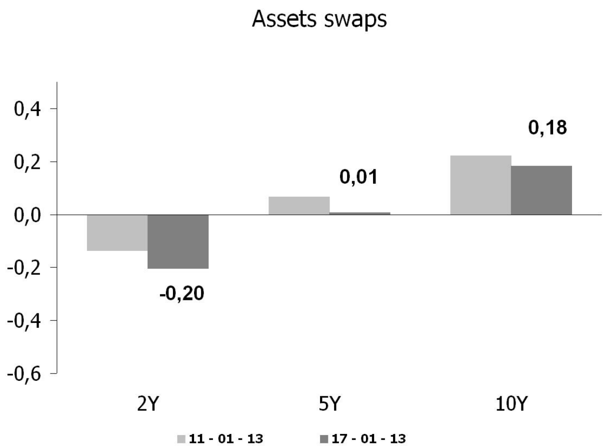
Fixed income

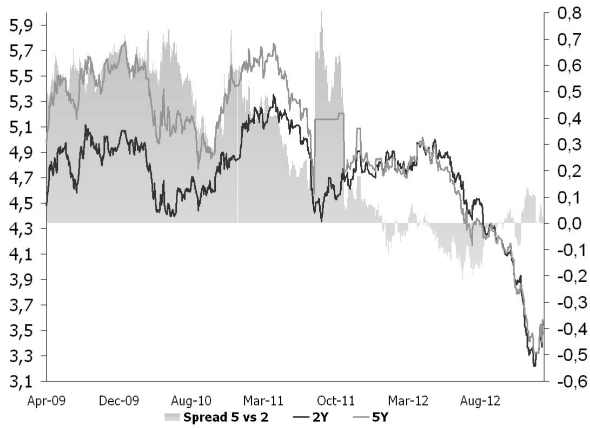
Weakness despite data

It's been quite an interesting and volatile week on Polish FI market with lots of flows and a huge set of macro data releases. Week started with continuation of a sell-off, with most supply hitting long end of the curve. After Tuesday's CPI data, which came out slightly lower than expected, some bids started to emerge and market finally found some sort of equilibrium. Inflation, both headline and core, was not enough to put the market back into rally, however it let some MPC members to change their tone a little more into dovish. Bigger surprise came from industrial output that fell by more than 10% y/y. We think the importance of this figure is bigger than market reaction would suggest, as it shows the direction of which the economy is going, and that recession we're facing is becoming a fact. We think it was too early for rate setters to announce an easing cycle approaching to an end and further data will allow for rate cuts to continue. On the other hand rising yields on core markets will add pressure to POLGBs in the long end and recessing economy will finally result in some worries about fiscal situation. All in all curve should steepen, significantly steepen and asset swap spreads widen.





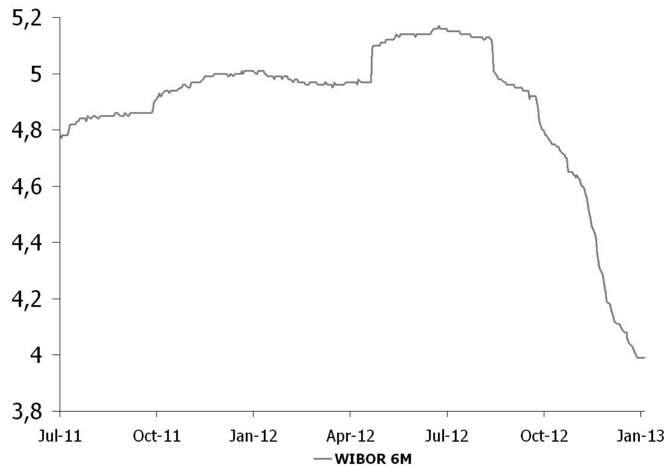


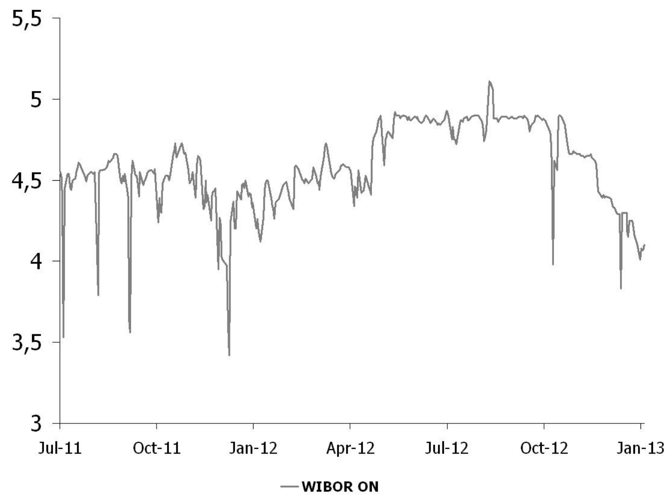


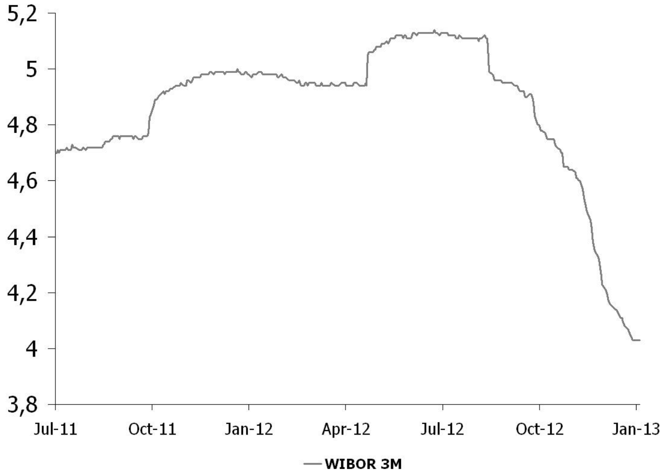
Money market

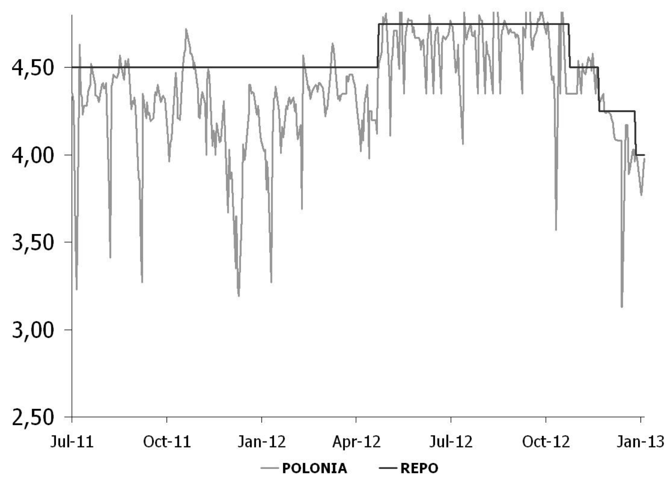
Significant OMO results. Cash rates should go higher next week since during today's OMO market bought almost pln 131 bn of money bills. Comparing to our calculations it looks like pln 5 bn over the amount needed to square the market. This should definitely be reflected in the shortest rates and disturb easy end of the reserve settlement period this month (risk of buying too little during next auction is significant).

Nasty sat of data but no move for front end rates. Longer rates surprisingly solid after a very negative set of real economy data published today. It looks like the whole market was trying to use it as an opportunity to pay rates, therefore the movement has not occurred. We agree that it makes February cut almost certain, however we also think that market can gradually increase the level of the main rate after the expected cycle. The lowest level implied from FRA rates was 2.75%. Right now its 3% and we can not exclude the switch to 3.25% very soon.







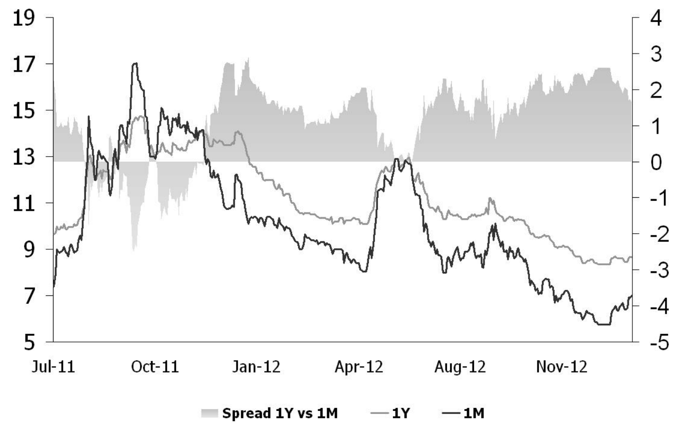


Forex

Breakout higher? This week the EUR/PLN was testing the upper band of the range, namely 4.1350. It withhold initial tests until really bad industrial production figure came out (-10.6 y/y against market expectations of -6.9!). The EUR/PLN moved swiftly through 4.1350/4.1450, and the way for 4.1700 is now being open. Now, we have to wait for the MPC comments, but it is the most likely that the need for further cuts will be vocalized. The short term perspective for PLN looks grim.

Higher. The volatility is in general better bid across the number of currency pairs, including leading ones like EUR/USD, EUR/JPY (not to mention EUR/CHF). It starts to influence the EUR/PLN volatility curve even though the realized volatility it s not really supporting, that just yet. The whole curve is higher with front end gaining 0.7% (1 month EURPLN ATM is now 7.1% mid) and the 1 year EURPLN mid is now 8.8 % (0.3 % higher than a last week). The current selling trend on skew and currency spread (USD/PLN vol minus EUR/PLN vol) shortly will be reversed.

EURPLN volatility



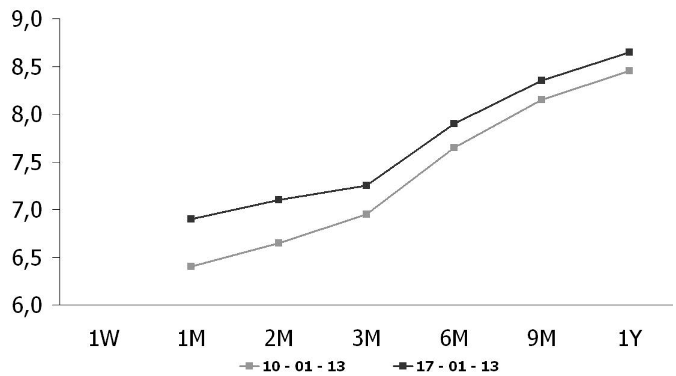
Short-term forecasts

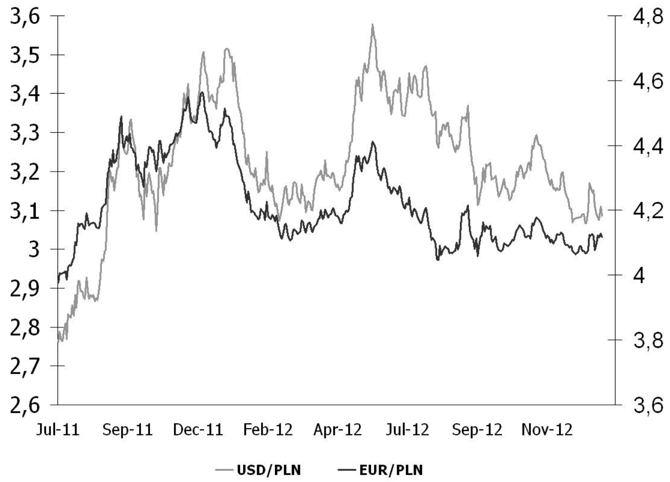
Main supports and resistances
EUR/PLN: 4.0900 / 4.13800
USD/PLN: 3.0600 / 3.2000

Spot. The upper resistance of the range is now broken. We still need that to be confirmed by daily/weekly close but when macro story gets sour, the technical picture is not the most important. We went long EUR/PLN 4.1400, will add 4.1250 with stop at 4.10 and hopes for 4.1850.

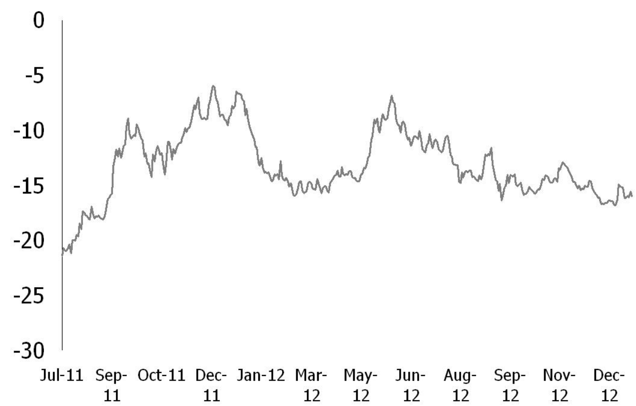
Derivatives. We are staring to think that selective longs in mid curve of the curve of EURPLN are a good option positions-wise. We still need the confirmation from the realized volatility to show more aggressive bids on the market. The preferred strikes are close to ATM.

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
1/11/2013	3.89	4.03	3.79	6.49	3.67	6.59	3.86	3.61	3.32	3.29	3.29	3.36
1/14/2013	3.79	4.03	3.72	3.89	3.66	3.78	3.87	3.64	3.39	3.32	3.33	3.44
1/15/2013	3.81	4.03	3.82	3.89	3.72	3.78	3.89	3.64	3.36	3.33	3.31	3.40
1/16/2013	3.80	4.03	3.80	3.89	3.69	3.78	3.86	3.60	3.35	3.28	3.30	3.38
1/17/2013	3.80	4.03	3.85	3.89	3.75	3.78	3.84	3.57	3.33	3.27	3.31	3.36

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
1/11/2013	6.590	3.353	3.292	3.275	3.420	3.351	3.630	3.873
1/14/2013	3.780	3.114	3.263	3.148	3.370	3.270	3.575	3.755
1/15/2013	3.780	2.992	3.218	3.137	3.325	3.237	3.525	3.759
1/16/2013	3.780	2.992	3.218	3.137	3.325	3.237	3.525	3.759
1/17/2013	3.780	2.992	3.218	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
1/11/2013	6.45	6.95	7.65	8.45	8.45	3.09	0.72
1/14/2013	6.93	7.18	7.83	8.63	8.63	3.09	0.72
1/15/2013	6.90	7.25	7.85	8.65	8.65	3.11	0.71
1/16/2013	7.00	7.30	7.90	8.65	8.65	3.11	0.71
1/17/2013	6.90	7.25	7.90	8.65	8.65	3.11	0.71

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/11/2013	4.0996	3.0890	3.3693	3.4739	1.3878	0.1598
1/14/2013	4.1231	3.0828	3.3674	3.4491	1.3864	0.1611
1/15/2013	4.1151	3.0750	3.3330	3.4610	1.4013	0.1607
1/16/2013	4.1280	3.1097	3.3437	3.5317	1.3983	0.1615
1/17/2013	4.1178	3.0853	3.3129	3.4611	1.4091	0.1612

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