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Comment on the upcoming data and forecasts

Last week before Easter with only quarterly current account data and inflation expectations publications. Inflation expectations are adaptive and usually reflect the most recent CPI figure known to the general public during the survey. In periods of dynamic disinflation (such as the one we are experiencing right now) expectations have a tendency to dive even lower, hence our forecast.

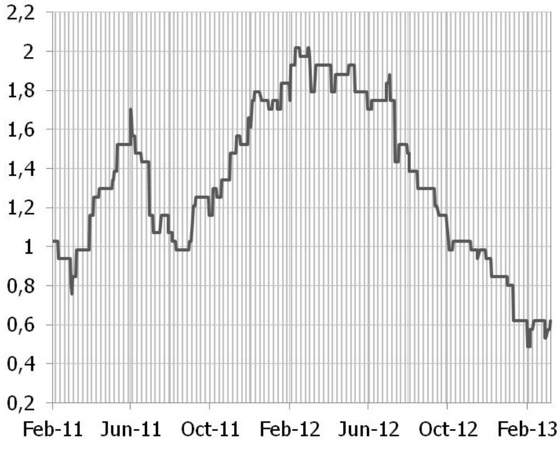
Polish data to watch: March 25th to March 29th

Publication	Date	Period	BRE	Consensus	Prior
Current account (mln EUR)	28.03.		-3900.0	-3436.0	-3367.0
Inflation expectations y/y (%)	29.03.		1.5	1.7	2.2

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Last yield (%)	Prev auction
52 Week T-bills	-	3000	3.485	3/4/2013
2Y T-bond OK0715	-	3000	3.170	3/22/2013
5Y T-bond PS0418	-	3000	3.432	3/22/2013
10Y T-bond DS1023	-	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

Surprise index grew after higher wages and lower unemployment rate. We do not see it however as a sign of a new trend, but rather one-offs influence (read more in *Economics* section). We expect index consolidation.

* 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

- We see more risks towards stagnation (not contraction) in H1 2013. External developments (moderate growth in Germany set to come no sooner than at the turn of H1/H2, zero growth in euro zone) are not dynamic enough to offset deceleration in domestic demand. Consumption growth close to zero (low 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.
- A faster re-acceleration of the euro zone economy and low statistical base seem to be the most obvious reasons for a rebound of the Polish economy in H2 2013. However, given the scale of slack in investment and consumption, any rebound generated this way may be only moderate (about 2%y/y growth rates in Q4 2013). 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. The government prepares the markets for a budget revision (Kotecki: „a revision should be regarded a standard step given volatile growth conditions").
- 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 much below 1% in Q2 2013. The possibility for significant undershooting of inflation target in 2013 is high.
- Although the MPC tried to communicate the end of the easing cycle after 50bp cut in March we believe one more cut is possible on the basis of weak macroeconomic conditions.

Financial markets

- 2013 most likely not a "bond year". Ultimatelly, global "rotation" of assets poses headwind for debt.
- Bullish on short-term bonds. MPC (through steepening of the curve) made also long-term papers more attractive and provided foreign investors with arguments against leaving the Polish bond market. Increasing the so called roll-down might favor increases in domestic investors' duration.
- Polish long term bonds now even more sensitive to core markets developments (both extreme risk aversion and risk apatite not favorable for Polish bonds).
- Ultimately, 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.
- We still expect POLGB's to stay at historically low levels (10Y below 4.50% in yield).
- Cyclical behavior of the Polish zloty far more moderate 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	2013 F
GDP y/y (%)	5.1	1.6	3.9	4.3	2.0	1.0
CPI Inflation y/y (average %)	4.3	3.5	2.8	4.2	3.7	1.0
Current account (%GDP)	-5.3	-1.6	-4.5	-4.9	-3.6	-2.5
Unemployment rate (end of period %)	9.5	12.1	12.4	12.5	13.4	14.2
Repo rate (end of period %)	5.00	3.50	3.50	4.50	4.25	3.00

	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.6	2.3	1.4	1.1	0.5	0.9	1.4	2.0
Individual consumption y/y (%)	1.7	1.2	0.1	-1.0	0.4	1.0	1.8	2.3
Public Consumption y/y (%)	-0.8	0.5	0.2	0.2	0.5	0.5	0.5	0.5
Investment y/y (%)	6.0	1.3	-1.5	-0.3	-3.0	-3.0	-2.0	-1.5
Inflation rate (% average)	3.9	4.0	3.9	2.9	1.4	0.9	0.8	1.0
Unemployment rate (% eop)	13.3	12.4	12.4	13.4	14.4	13.9	13.5	14.2
NBP repo rate (% eop)	4.50	4.75	4.75	4.25	3.25	3.00	3.00	3.00
Wibor 3M (% eop)	4.94	5.13	4.92	4.11	3.40	3.20	3.20	3.20
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.14	3.10	3.10	3.10	3.10
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.74	3.80	3.90	4.00	4.20
EUR/PLN (eop)	4.15	4.22	4.12	4.08	4.15	4.10	4.05	4.00
USD/PLN (eop)	3.11	3.35	3.20	3.09	3.14	3.21	3.24	3.20

F - forecast

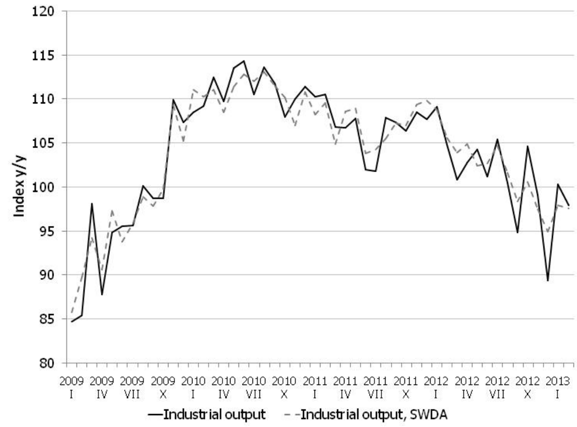
Economics

Weak state of the economy justifies further cuts

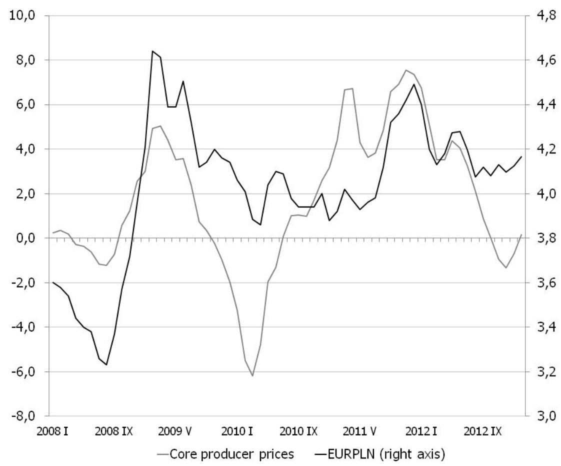
This week brought the last package of February data, which relatively unanimously reflected further weakening of the Polish economy. Further decreases of industrial and construction output on the annual basis, slightly lesser in magnitude but still deteriorating conditions on the labor market (higher growth of wages is an outlier) having impact on retail sales together, and finally the latest inflation surprise (an euro-wide phenomenon given expectations for a deflation in euro zone), do not paint a positive picture. Recent data only confirm our forecast of a very weak H1 2013 (GDP growth in Q1 lower by more than a half compared to Q4'2012) and a stagnation scenario put forward most recently by A. Bratkowski from the MPC. It means that output gap grows and decreasing inflation de facto tightens monetary policy - Polish economy enjoys 2%+ real rates, which contrasts with uniformly negative rates in EU, and also Taylor rule implied rates (below 3%) based on NBP forecasts. Therefore, the room for maneuver for the MPC remains significant, especially that the cyclical necessity to rebuild savings rate makes real rates level almost insignificant for the propensity to save. Although the „Minutes" from the March meeting reveal that pain threshold for many MPC members is high, it has probably drifted lower after recent publications and is set to be tested further along with incoming publications (still weak given - maybe not fully recessional but still sorry - state of the economy). We expect another 25bp cut (May-July). However, do not get used to the scale - it is rather a signal that further movements are possible; with such divided MPC the question of the scale of easing is much harder than making the easing call alone.

Below we present short summary of the data published during this week.

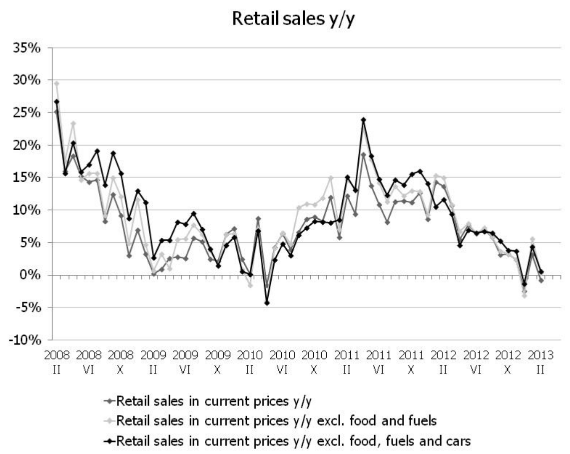
- Annual growth of **wages** accelerated sharply from 0.4% to 4.0% in February (market consensus 2.7%, our call 3.7%). Such a growth stems from statistical effects and has to be linked to shifts in last year's wage payments. Therefore the true trend is closer to 2.0-2.5%. Owing to weak economic activity, next months are unlikely to bring a significant acceleration, the more so since enterprises stay very cost-sensitive.
- As for **employment**, firms shed 8k of jobs. This translates into stagnant -0.8% y/y growth of employment in January and February. After statistical disturbances in January firms did not revive sharp employment cuts from the end of the last year. Therefore we think that the most significant drops are behind us. However, it does not mean that the period of weak employment figures is over. GDP growth in H1 is going to be insufficient to change the trend in employment growth which is likely to oscillate around -1% in coming months.
- **Industrial output** dropped by 2.1% y/y after a 0.3% rise in January. In seasonally adjusted terms output contracted by 2.4% y/y. We did not spot any signs of an exports-led recovery of Polish manufacturing. Exports-oriented sections recorded biggest drops. In addition, February data might have been skewed to the upside as an aftermath of the very weak end of 2012 (as was also the case in January).



- **Construction output** dropped by 11.4% on annual basis (seasonally adjusted -12.2%). A turnaround in construction is, however, nowhere in sight. First, a slight increase in year-on-year dynamics is probably attributable to more favorable weather conditions. Second, the slump is observed both in residential and infrastructural investments. Double-digit declines in the coming months are bound to occur on base effects (preparations to EURO 2012) alone. Finally, any positive signals from either the residential sector, or public investments are still beyond the horizon. As for the former - Friday's data on housing starts and permits confirm weakness. As for the latter - a real push will arrive with new EU funds (i.e. in 2014).
- **Producer prices** went down by 0.4% y/y after they dropped by 1.2% in the prior month. The turnaround stems mostly from statistical base effects. The momentum in producer prices is still moderate. In core terms (excluding prices of oil and coke) monthly growth came out at 0.2% (0.3% in the prior month). The next three months are poisoned with statistical base effects, therefore the recent behavior of producer prices is unlikely to mark a turnaround in annual growth. We expect a minimum to be reached in May (below minus 1-1.5%) so at the moment disinflation progresses in full throttle.



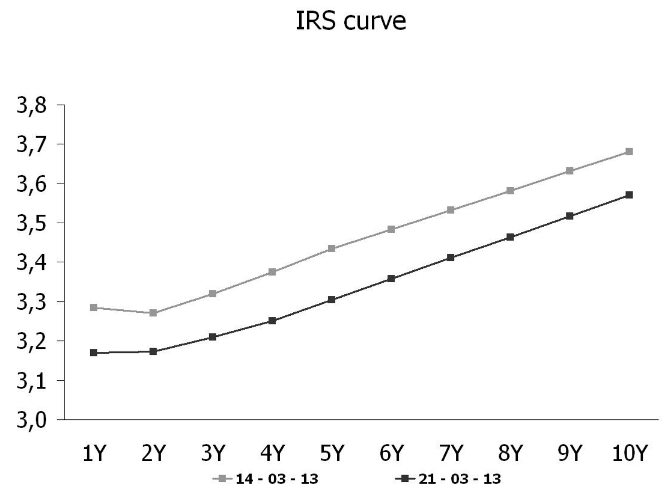
- **Retail sales** dropped in February by 0.8% y/y after 3.1% growth in January. Positive statistical effects from the previous year as well as the idea of positive impact of delayed payments to farmers (put forward by us) at the beginning of the new year should be yet forgotten. In February - similarly to 2009, when the working days distribution was the same (-1 y/y, -2 m/m) - sales increased only in two categories (and among them food sales grew nominally by only 0.2% m/m and dropped in the real terms by 0.8%). The most influential categories (in terms of contribution to retail sales drop) were fuels (-5.2% m/m in nominal terms and -5.7% m/m in real the terms - similar numbers point that such a drop reflects cyclical behavior of the economy and weak demand rather than price effects, which strengthens the negative interpretation of the headline data), other non-specialized stores (-4.6% m/m) and motor vehicles (-2.6% m/m). Such distribution of sales within categories results in slight growth of core retail sales - when fuels, food and motor vehicles are excluded it varies between 0.3-1.0% y/y. In real terms patterns are similar - headline dropped by 1.3%, core increased by 0.8%.



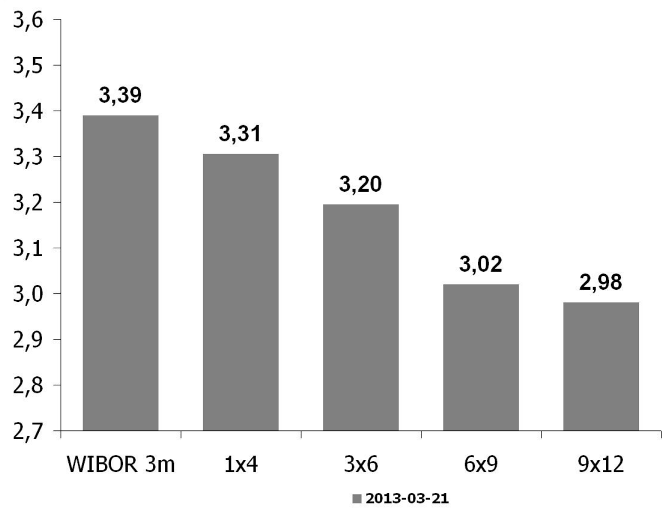
Fixed income

Be aggressive

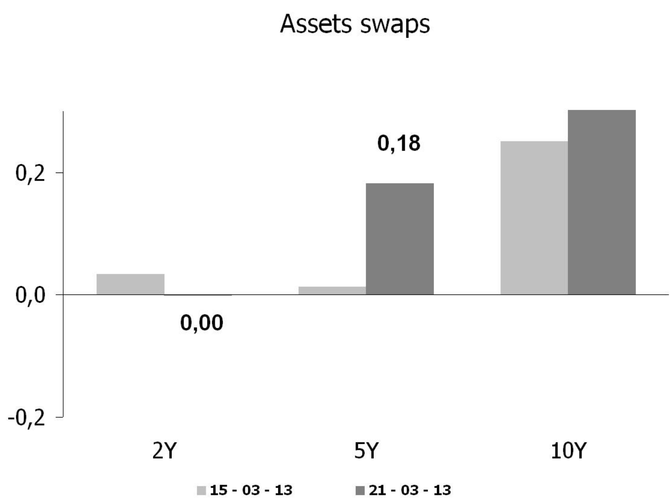
Last week we had quite a significant sell-off in longer end bonds accompanied with pretty heavy widening of ASW spreads. Longer end bonds widen to some 35 bp (+15 bp move within a week), 5y bonds also traded pretty weak. The reason was partly external (Cyprus) and partly local (MinFin 5y bond auction and unconventional move to increase auction size by 2 bio PLN). We saw also some profit taking after CPI release from previous week. Sentiment was pretty bad and price action suggested some stops were triggered. Market was struggling to absorb extra liquidity from the secondary market as amount of market makers was quickly shrinking.

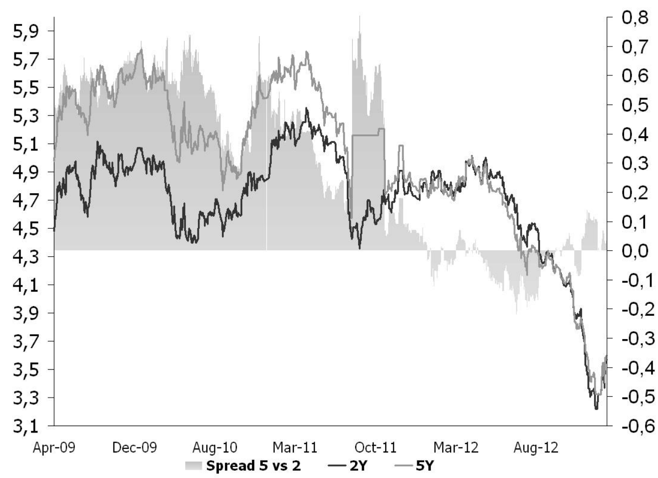


This is enough for bad news. Going forward, we start to see some pattern. Economic activity will remain weak for sometime, it is weaker to what MPC saw both in terms of real economy and nominal sphere. It also starts to transfer into fiscal position of Poland. Budget deficit shows weakness on the revenue side (confirming weak economic activity) and will be likely revised up (Kotecki, Head of MinFin research, pre-announced such a move in our opinion). Still the revision will have small impact in boosting GDP dynamics going forward. The burden to promote growth in Poland is definitely on the monetary side. With CPI below lower target range (there is a risk it will be very close to 0.5% in just 3 months), output gap negative for next 3 years and likely increasing more to expected in 2013 gives a big room to maneuver.



MPC may stick to end of the cycle, and wait and see language but not for very long. History shows MPC delivered what was needed (with slight slippage and very misleading communication) and they will be forced to deliver again. Rates in Poland have not bottomed out, but ASW prices, they might already have. We prefer rates to bonds, we like curve steepeners against 2y. We also still see risk of unconventional measures being promoted by NBP of MinFin to attract surplus liquidity in the system. We advice long bond position but only up to 5y sector and we think that floating rate bonds are mispriced. Plenty of opportunities in this market.

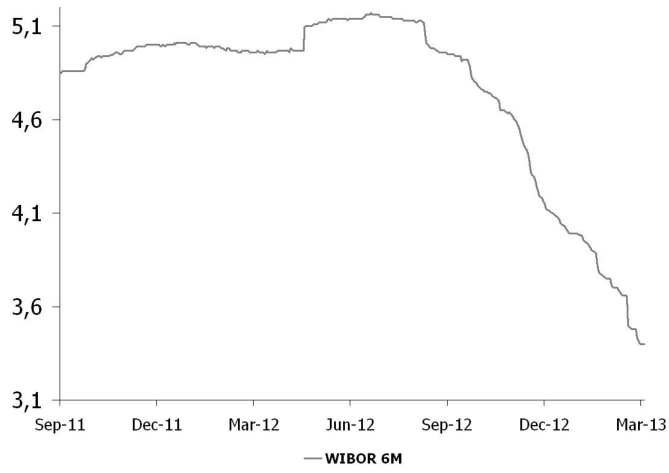


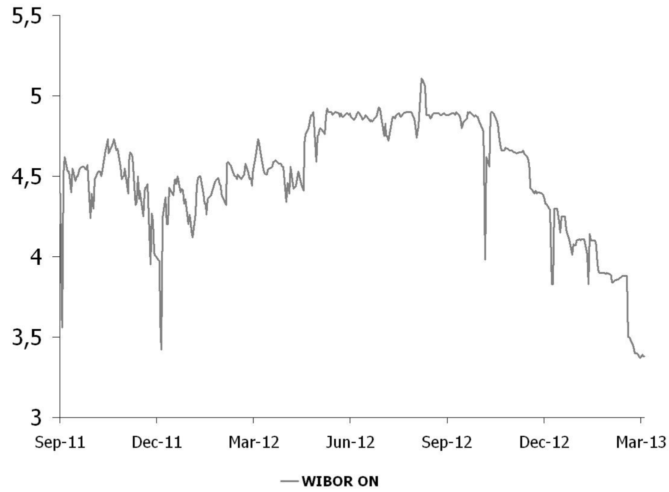


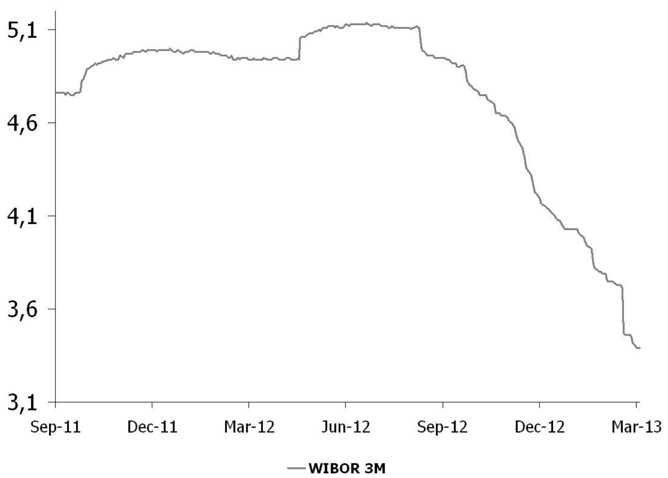
Money market

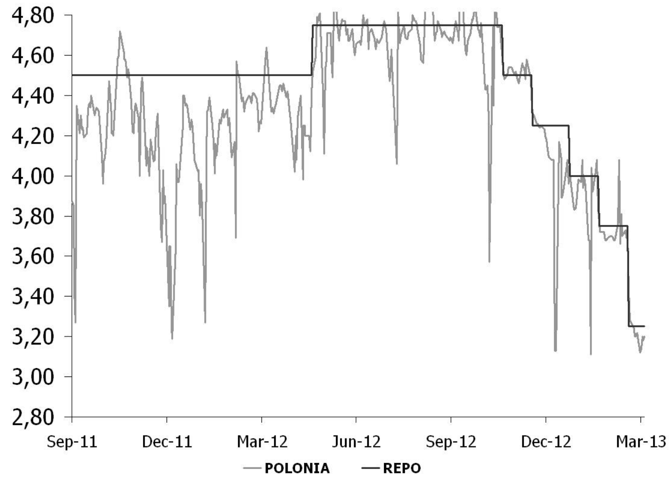
Shortest rates should be lower before Easter. Today's OMO seems to square the market for the last week of the reserve. However, usually before any holidays the cash tends to be cheaper. Also this time we bet on such a scenario.

Some fuel for bulls from the local and global data. Quite a volatile week for the rates but within a range. As of now the bulls are taking advantage after weaker then expected local retail sales data and weaker PMI's from the global economy. Also Mr's Bratkowski comments were quite helpful for receivers suggesting possibility of further rates cuts quite soon. We see this probability growing with each figure (low CPI vs weak industrial output, consumers demand etc). Having said that we now prefer bonds from the belly of the curve over rates and receiving Oiss vs Fras (Fra contracts discount 50 bps cut, Oiss only 35 bps).







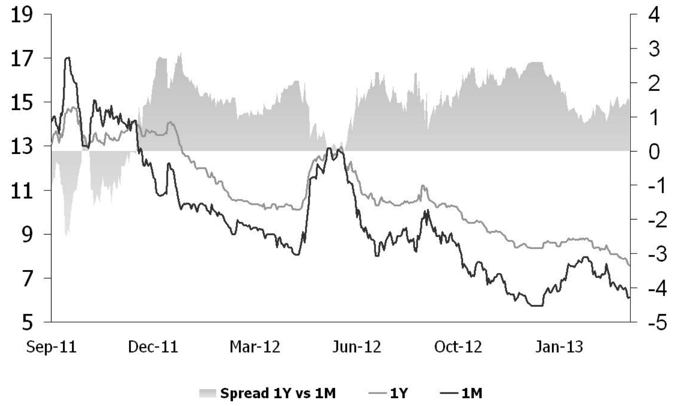


Forex

PLN weaker . The global sentiment (Cyprus) is to be blamed for a softer PLN performance. After briefly touching 4.14 on the Monday morning EURPLN reached 4.1940 high on Friday, when market sentiment changed from bad to worse. In general, Zloty is behaving really well, a few years ago, we would have moved 20 big figures plus. Merely 5 figures move, confirms that PLN is still enjoying its quasi safe heaven status. The government owned bank was seen on the offers. The situation is getting more interesting, renewed expectations of further rate cuts are fluctuating in the markets adding same uncertainty.

Tic lower. The EUR/PLN vols curve is generally unimpressed by current PLN weakness. Instead of going up, we have seen a small decrease in vols. 1 month EUR/PLN atm mid is today 6.2% (0.1 % lower than a last Friday), 3 month EUR/PLN mid marks 6.6% (down by0.3%), 1 year is fixing at 7.7 % (0.1% down). USD/PLN on the other hand is a different king of animal. The currency spread (difference between USD/PLN vol and EUR/PLN vol) soared, especially in the front end 1 month C/S is now 5.5%, 1% higher then the last week.

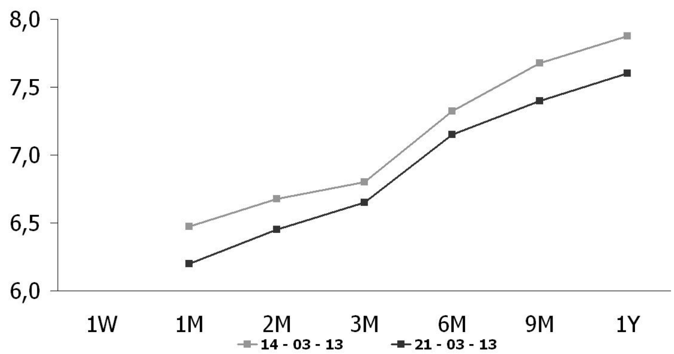
EURPLN volatility



Short-term forecasts

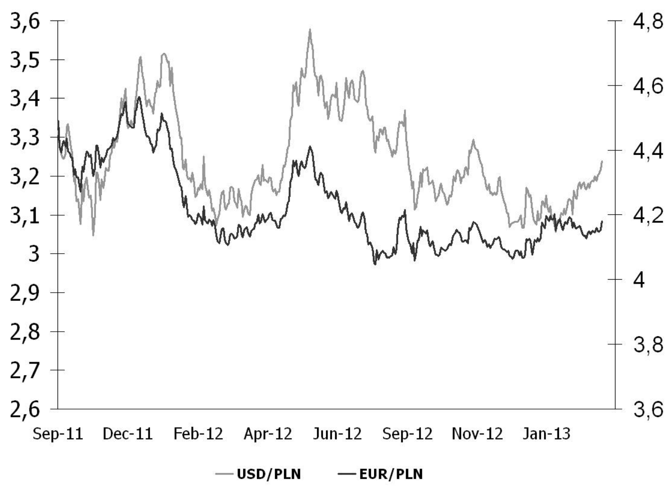
Main supports and resistances
EUR/PLN: 4.1250 / 4.2000
USD/PLN: 3.1500 / 3.3000

EUR/PLN volatility curve



Spot. Just when I wrote play the range with full conviction, it seems that the upper band is in danger of giving way (such is life!). We stick to our play range approach but simply take into consideration the risk of over shooting. We sold 4.1900 would like to add 4.2050 with a stop above 4.22 and hopes for move bellow 4.14.

Derivatives. Unchanged. We have changed our selective Vega buying recommendation to a neutral one. The realized volatility is constantly descending (especially if we look at daily basis). I does not bode well for Vega longs. The vols are cheap, in comparison to the historic ones, but they are quite expensive to the realized volatilities. Stay aside.



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
3/15/2013	3.20	3.42	3.33	6.49	3.36	6.59	3.30	3.21	3.08	3.03	3.10	3.12
3/18/2013	3.09	3.40	3.16	3.30	3.21	3.30	3.31	3.18	3.03	3.01	3.06	3.09
3/19/2013	3.09	3.39	3.25	3.30	3.36	3.30	3.29	3.19	3.05	3.02	3.06	3.09
3/20/2013	3.09	3.39	3.15	3.30	3.24	3.30	3.31	3.18	3.05	3.02	3.06	3.09
3/21/2013	3.17	3.39	3.17	3.30	3.22	3.30	3.31	3.20	3.02	2.98	3.03	3.05

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
3/15/2013	6.590	3.353	3.292	3.275	3.420	3.351	3.630	3.873
3/18/2013	3.300	3.114	3.263	3.148	3.370	3.270	3.575	3.755
3/19/2013	3.300	2.992	3.218	3.137	3.325	3.237	3.525	3.759
3/20/2013	3.300	2.992	3.218	3.137	3.325	3.237	3.525	3.759
3/21/2013	3.300	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
3/15/2013	6.55	6.90	7.35	7.90	7.90	2.86	0.73
3/18/2013	6.38	6.83	7.30	7.83	7.83	2.86	0.73
3/19/2013	6.10	6.70	7.15	7.65	7.65	2.88	0.73
3/20/2013	6.13	6.65	7.10	7.58	7.58	2.88	0.72
3/21/2013	6.20	6.65	7.15	7.60	7.60	2.90	0.72

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
3/15/2013	4.1595	3.1868	3.3770	3.3120	1.3652	0.1629
3/18/2013	4.1505	3.2015	3.3969	3.3712	1.3493	0.1620
3/19/2013	4.1465	3.2055	3.3860	3.3610	1.3576	0.1621
3/20/2013	4.1538	3.2169	3.3999	3.3753	1.3660	0.1619
3/21/2013	4.1805	3.2387	3.4240	3.3937	1.3707	0.1623

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