BRE BANK SA

POLISH WEEKLY REVIEW

April 19, 2013

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Comment on the upcoming data and forecasts

On Monday Eurostat will publish Polish (among others) data on General Government deficit in 2012. The government hoped to reduce the GG deficit to 3.5% of GDP, probably sufficiently low for the European Commission to close the Excessive Deficit Procedure. Despite the fact that state budget performed pretty well during 2012 (at least at first glance), we believe that the above mentioned target might be missed and we may end up closer 4%. As local governments successfully consolidated their finances, risks come from the central government sector, mainly from the National Road Fund - a 30B PLN off-budget vehicle which finances all public investments in state roads.

On Tuesday last package of March data - Statistical Bulletin with detailed data on retail sales and unemployment rate. Although Easter has usually great influence on the former, this year seems different especially due to weather anomalies affecting not only others category (building materials), but also clothing and footwear. No support comes also from vehicles sales and high base from the previous year on the mentioned "other" category. All in all we forecast negative headline, lower than market consensus. As for the second reading, we may witness a mysterious seasonal drop (according the the data from the Labor Ministry); seasonally adjusted unemployment rate seems stable (to be certain let's wait 2-3 months to avoid end of sample bias).

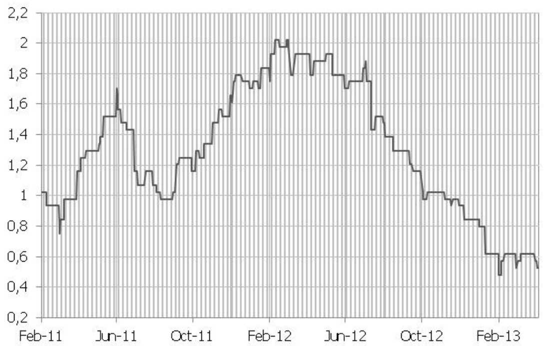
Polish data to watch: April 22nd to April 26th

Publication	Date	Period	BRE	Consensus	Prior
GG deficit (% of GDP, EU methodology)	22.04.	2012			5.0
Retail sales y/y (%)	23.04.	Mar	-0.7	0.6	-0.8
Unemployment rate (%)	23.04.	Mar	14.4	14.4	14.4

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	4/25/2013	3000	3.170	3/22/2013
5Y T-bond PS0418	4/25/2013	3000	3.432	3/22/2013
10Y T-bond DS1023	-	3000	3.515	4/11/2013
20Y T-bond WS0429	-	4000	3.896	1/7/2013

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



Comment

All this week data surprised market more or less negatively. Surprise index dropped slightly trying once more to break the side movement. Although incoming data remain negative we do not expect great downtrend anymore.

* 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 mid-term on lower core inflation (below 1% in mid 2013). CPI inflation much below 1% in Q2 2013. The possibility for significant undershooting of inflation target in 2013 is our base case.
- Although the MPC tried to communicate the end of the easing cycle after 50bp cut in March, we believe cuts are still in the pipeline on the basis of weak macroeconomic conditions, persisting low interest rates environment in Europe and low inflation. So far we expect 75bp more.

Financial markets

- Given our below consensus view on growth and NBP rates we stay bullish on short-term bonds. Note that NBP may also use uconventional tools to boost banks’ demand for government papers.
- Over the next few months we are also constructive on Polish long term bonds. MPC (through steepening of the curve) made long-term papers more attractive and provided foreign investors with arguments against leaving the Polish bond market. No major credit repricing of POLGBs yet (budget adjustment seems to be already priced in). Poland will preserve its quasi safe haeven status and benefit from low yield environment in Europe.
- Ultimately, global recovery (or monetary stimulus withdrawal) and rising core yields may adversely affect Polish bonds (only modestly higher yields). This, however, seems to be a strory for more distant future (6 months plus).
- 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 strong resistance.
- Volatility on both FX and FI lower.

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	1.1
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	2.50

	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	0.4	0.8	1.2	1.7
Individual consumption y/y (%)	1.7	1.2	0.1	-1.0	0.3	1.0	1.6	1.9
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	-4.5	-4.5	-3.0	-2.5
Inflation rate (% average)	3.9	4.0	3.9	2.9	1.4	0.7	0.5	0.7
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	2.75	2.50	2.50
Wibor 3M (% eop)	4.94	5.13	4.92	4.11	3.39	2.95	2.60	2.60
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.14	3.19	2.65	2.65	2.65
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.74	3.94	3.30	3.40	3.60
EUR/PLN (eop)	4.15	4.22	4.12	4.08	4.18	4.15	4.05	4.00
USD/PLN (eop)	3.11	3.35	3.20	3.09	3.26	3.25	3.24	3.20

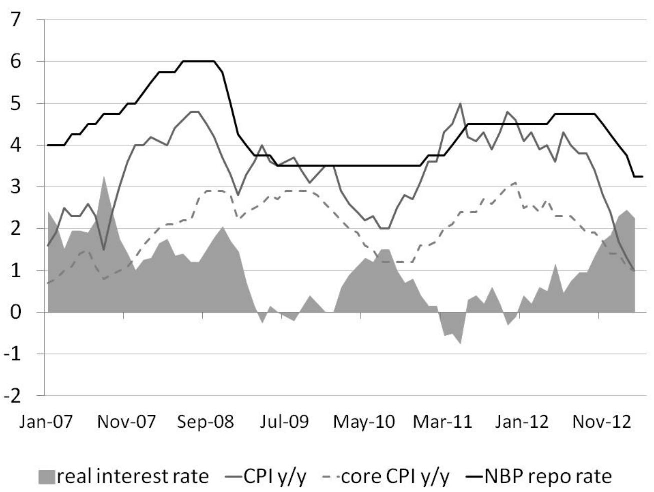
F - forecast

Economics

No rebound in the economy. We expect further rate cuts.

Almost two series of monthly data passed since the last MPC meeting when rates were cut. And despite high expectations of a rebound in the economy... nothing even resembling one materialized. The fresh reading on industrial output corroborates our earlier forecast that **Q1 is going to be weaker than Q4 and we estimate GDP growth in the vicinity of 0.5% y/y**. Q1 will be marked with a little more agile (above but close to zero) consumption but considerably lower investment activity. The cycle did not turned the corner in Q1 as MPC had expected.

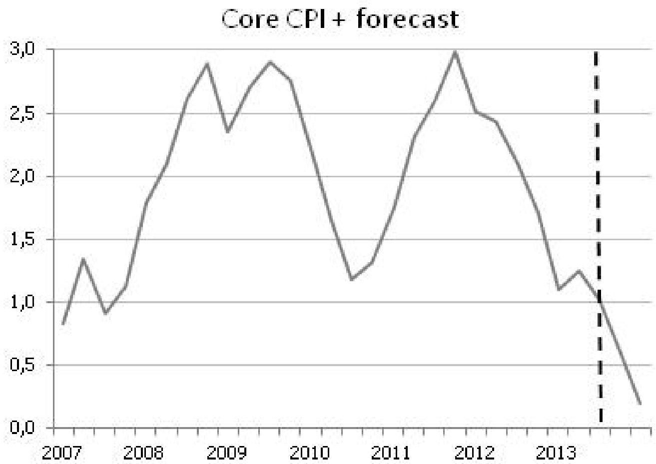
Therefore, we think that in an environment of negligible inflation MPC can afford generous rate cuts and the return to easing can be a spectacular one. We expect that the Council may start with 50bps in June (the risk for a cut in May is non-negligible but the meeting will be rather utilized to prepare the markets for a possible change in the following month). And we are more and more inclined to say that 2% target in rates does not seem to be a sheer folly. At least we cannot exclude that the market may price-in such a future level of rates. The more so since many investors have recently lost traction of the differences between Poland and Czech Republic and start to think that the former starts to resemble the latter.

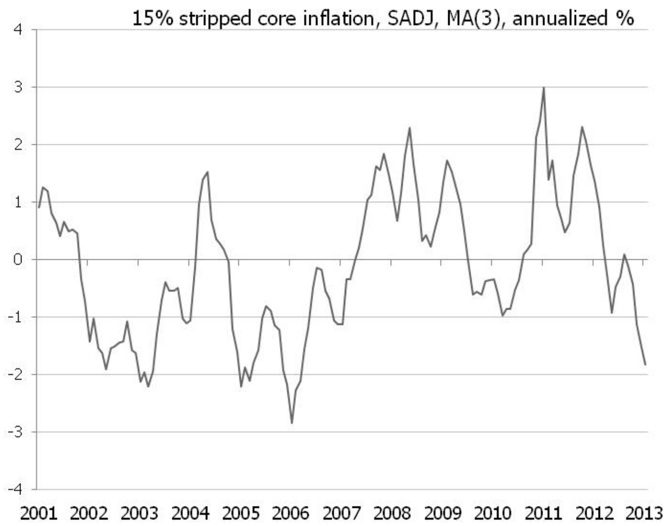


Below we present our detailed assessment on the recent publications. We also summarize the findings from the fresh NBP survey. It confirms that the first quarter of 2013 did not bring any improvement in economic conditions.

Another month with lower inflation. Annual inflation rate decreased in March from 1.3% to 1.0%. In line with our expectations and trends in the region, drops resulted mainly from lower food inflation. Core CPI (excluding food and energy prices) also decreased by 0.1pp. to 1.0% as a consequence of significant drop in telecommunication service prices (due to regulatory changes, again), outweighing one-off growth of prices in recreation and culture category (+1.7% m/m, connected with some new offers in satellite TV). Dwelling prices, that usually have positive contribution to inflation, this time remained stable in March.

Disinflation in both the whole basket and core categories continues - we expect CPI to reach minimum in June (ca. 0.5-0.6%). Consumer prices react with some delay to low economic activity (wide output gap), low wages and drops of producer prices, which all constitute today's Polish reality. Therefore we do not see much space for core CPI gaining pace in the second half of the year, which is confirmed by our model based on individual consumption and exchange rate (see chart). This scenario is also supported by global more and more pronounced fears of deflation (especially in Europe).



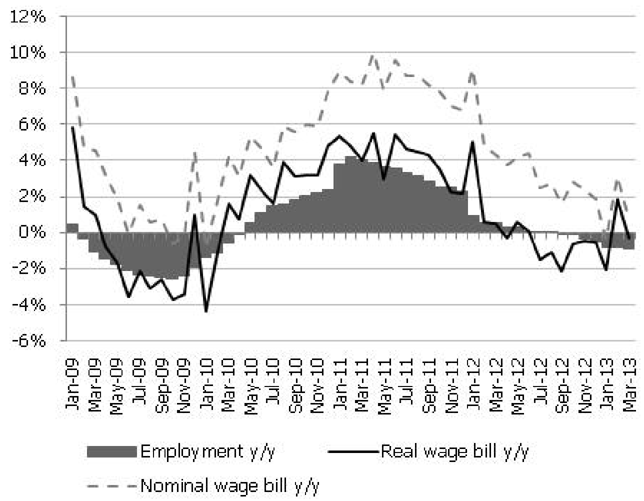


The strong disinflation can be also confirmed by simply looking at seasonally adjusted core measures (we particularly like the one that strips the 15% of goods that registered biggest increases and decreases). The problem with Polish core inflation is that it is poisoned with various one-offs that blow up ARIMA-based seasonal adjustment methods. Therefore, we returned to the ancient methods of seasonal adjustments and mechanically corrected for seasonality in every month, using monthly growth rates. The ensuing series was still a bit unstable, but using MA(3) solved the problem. In the end we annualized the data in every month ("American" way). Such an attitude towards inflation data solves the problem of "base effects" which pop up in some of rate-setters comments and serve as a base for thinking that inflation's fall is statistical.

Not really - inflation is falling because its momentum is very weak. Results are presented in the graph and yell one word ”disinflation”.

Weak labor market. Employment in the enterprise sector dropped in March by 0.9% y/y (in line with expectations) after a 0.8% drop in February. In absolute terms there were almost 9k less job positions, which is a better result than in 2009, but noticeably worse than implied by seasonal pattern. In spite of still low economic activity (latest NBP survey although confirms pessimistic outlook on employment, indicates that firing is not a dominant employment strategy anymore), we see unusually harsh weather in March as an important factor determining changes in the real economy.

Wages grew in March by 1.6% y/y in line with our forecast (1.8%) and significantly below market consensus (2.8%). More details on the distribution among various sectors will be published on Monday in the Statistical Bulletin (for both wages and employment), but according to our predictions wages surprised on the downside mainly due to poor performance of manufacturing and construction sectors, coupled with unfavorable weather conditions and negative working day effects, as well as irregular shifts of bonuses in certain sectors (telecom services). With wage dynamics close to 2.0% for several months so far, it is clear that there is no significant wage pressure in the economy. Labor market remains now ”employers’ market” (which literally means that employers do not need to encourage workers with higher wages) and mentioned new NBP’s survey results do not leave much space for change in this matter in the months to come.



All in all, there are no signs of improvement on labor market (the only good news is the lack of bad news), which supports low demand forecasts based on self-imposed wage discipline and cyclical necessity to rebuild savings rate. With still negative real wage bill annual growth rate (-0.3% in March) income base for consumption is supported only by social benefits and pensions independent from economic situation.

Industrial output fell by 2.9% on annual basis, slightly deeper than consensus and our own forecast (-2.5% both). In seasonally adjusted terms, industrial output registered a slight increase (by 0.6% - first time since October) but it would be reasonable to restrain optimism (seasonal adjustment can be tricky). On a monthly basis, production grew only by 9.2% which makes the previous month the worst March since 2008. This happened despite a favorable difference in working days (+1 m/m). The drop can be partly attributed to unfavorable weather conditions which disrupted production and transport but raised electricity and heat production. Production fell in 20 branches and no meaningful pattern can be observed in detailed examination of the data. Certainly, exports-oriented sectors did not pull the economy upwards.

April might actually bring some improvement, as pent-up demand is realized and production is making up for winter-related delays and disruptions. With low statistical base from last year, expectations of a 1.5-2.0% annual growth are thus not unreasonable. However, this does not constitute a rebound - without a meaningful surge in demand industrial output will zigzag around zero for the foreseeable future.

In March **construction output** dropped by 18.5% on annual basis (seasonally adjusted -12.2%). On monthly basis construction decreased by 3.3% (seasonally adjusted), which confirms impact of weather anomalies on the data (for the first time in many years March was colder than February). It is therefore not surprising that drops were recorded in all divisions of construction: civil engineering, construction of buildings and specialized construction activities. We have to stress though that weather could have subtracted only few percentage points from the headline number and the growth rate close to -20% reflects both continuation of slowdown in construction activity and base effects from the first half of 2012 (preparations to EURO 2012). The latter alone should keep negative double digit construction output growth rate at least till June. For any impulse from public sector we have to wait till 2014, when new funds from EU are set to flow in again.

Producer prices in March went down by 0.6% y/y. The reading was in line with our forecast. The disinflation on producers’ side is running in full throttle. It seems obvious given the sorry state of domestic demand and it was recently corroborated further by the results of the fresh business activity survey conducted by the NBP. Not only did enterprises lose pricing power but they also decreased their forecasts for future prices. We expect this process to be continued as long as GDP gap is yawning.

No upturn signs in the new NBP’s survey either. Contrary to some expectations, first quarter of 2013 did not bring any improvement in economic conditions. We see NBP’s survey results (both current assessment and future expectations) as indication of entrepreneurs' situation stabilizing on a low level, so once again the only good news is the lack of bad news. We would like to stress some interesting points of the NBP's report, though.

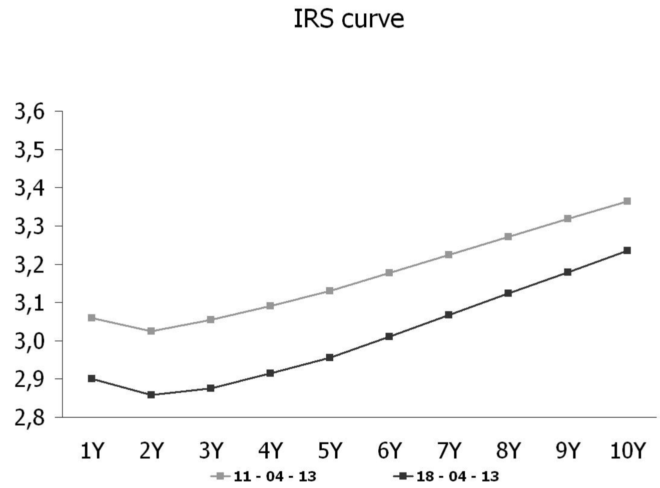
1. The divergence between exporters and non-exporters grows. While the former experience stabilization (although not seen in hard data, there was some improvement in assessment of new export orders and forecasts in Q1 2013), the latter become more and more pessimistic. Relative weakness of internal demand is also revealed by growing role of exports in Polish economy (in both share of exports in firms' revenues and share of exporters among surveyed firms). It also proves that companies, which cannot achieve sufficient scale effects on the domestic market, try to explore new foreign markets.
2. NBP survey tries also to answer one of the „big questions" regarding further improvements in the Polish economy, which is the scale of investment slowdown in 2013. After already released data we know that in the Q1 investment activity decreased y/y and further perspectives remain negative. Investment plans are developed only by the biggest companies and on much lower scale (in value), which results from uncertainty on future economic situation and to a lesser degree from poor demand, lack of financial sources or expensive loans (therefore, support from monetary easing remains limited). Therefore, an upturn in investment should be expected only when the positive outlook anchors.
3. Finally, survey results confirm our relatively positive assessment of firms' financial situation (e.g. liquidity, margins) and their cautiousness in financial management manifested for example by low demand for bank financing (nevertheless, in some sectors e.g. construction, supply of credit is a binding constraint).

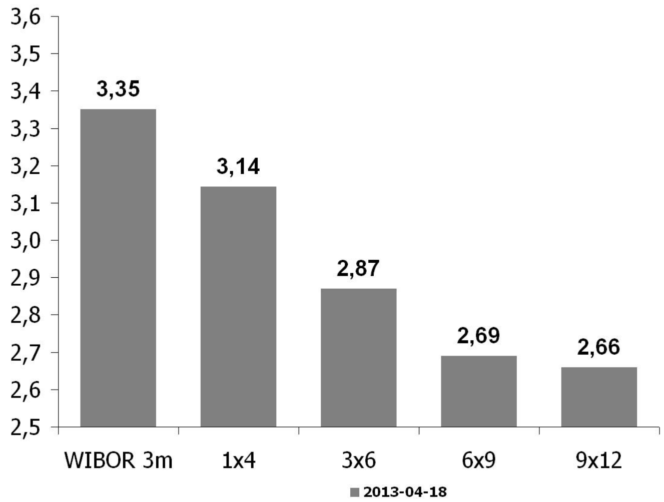
Fixed income

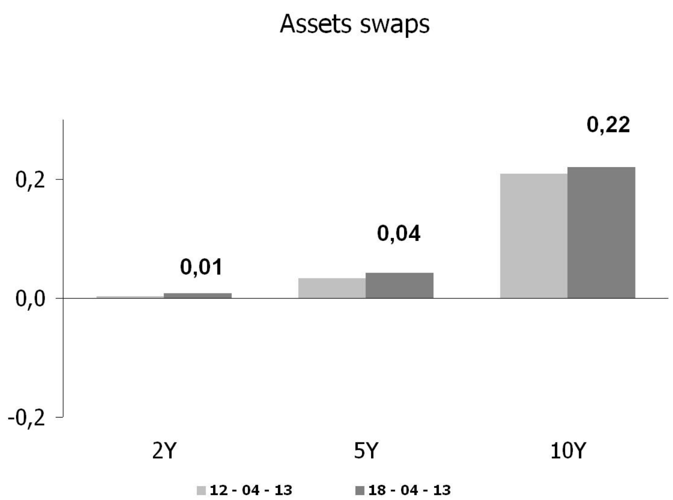
Wait and see

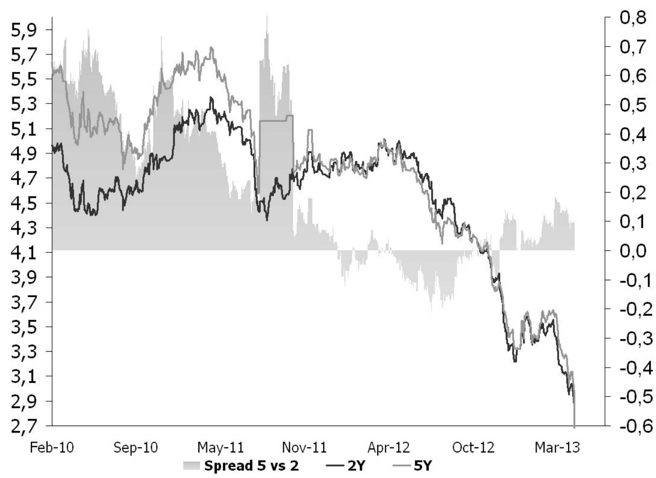
This was a week of data and MPC comments. All economic releases (without exception) came on the softer side. Most of the comments (even from hawkish wing of MPC) came on the dovish side, indicating willingness to ease rates maybe not in May but definitely before July. Here is our impression. MPC has a history of delaying decisions, which in the end forced them to make quite a costly policy mistake. We think that this time they will prefer to act rather than to make a mistake of exactly the same kind. While it is quite irrelevant if cut comes in May or in June, we think it is a cycle ahead of us.

As for the market. We are at ever lows in yields and bond prices (no wonder, right). Fuel for next legs in this rally looks to be limited, as there is only one data left (retail sales), big auction (up to 10 bio of bonds which are to be sold at record levels certainly looks as a risk) and after that MPC, which is in a wait and see mode. Moreover, on Monday we will learn GG official estimate, which is likely to be higher to 3.5% rising doubts about EDP, rating stability etc. Perfect set up if not for a sell off then definitely for some correction in bond prices. At a glance. But is it really ? Isn't it just the fact that market is not used to beating constantly new lows day after day? What I would like to describe as our strategy right now is "wait and see". We will wait and see when actually MPC cuts rates as much as they need to be cut. We will wait and see if actually there is any reason to expect rebound in H2 of 2013. We will wait and see how market will deal with growing liquidity not only in local market but also core markets that is pushing asset prices up doing little to help economy. We are long bonds up to 5y and we receive rates up to 2y and we wait. Let's see.





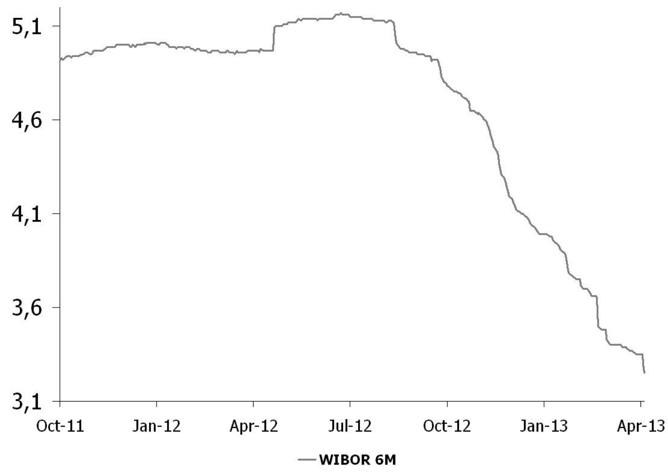


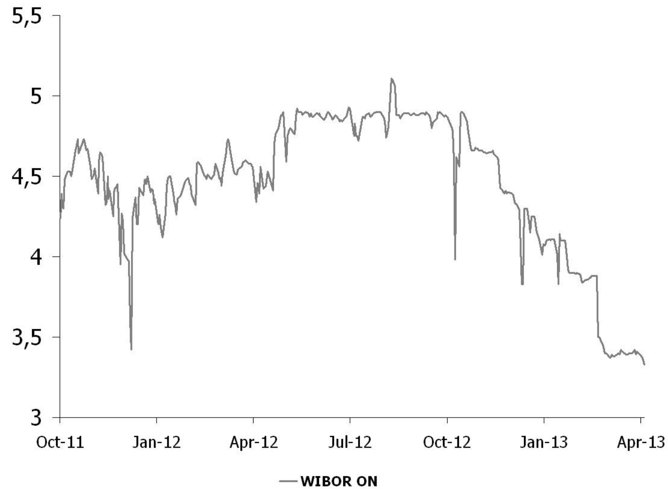


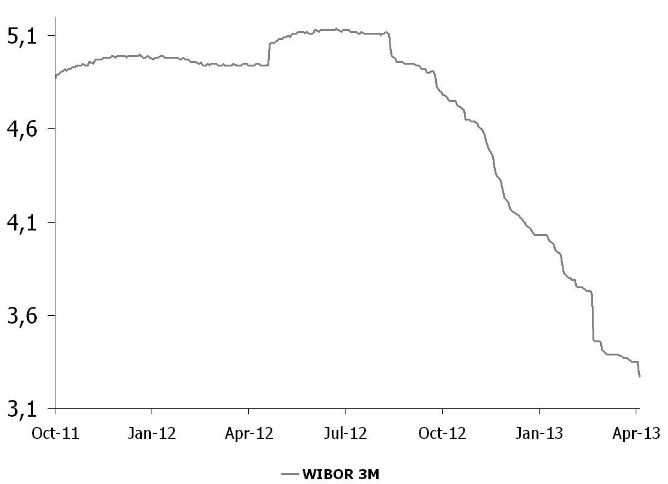
Money market

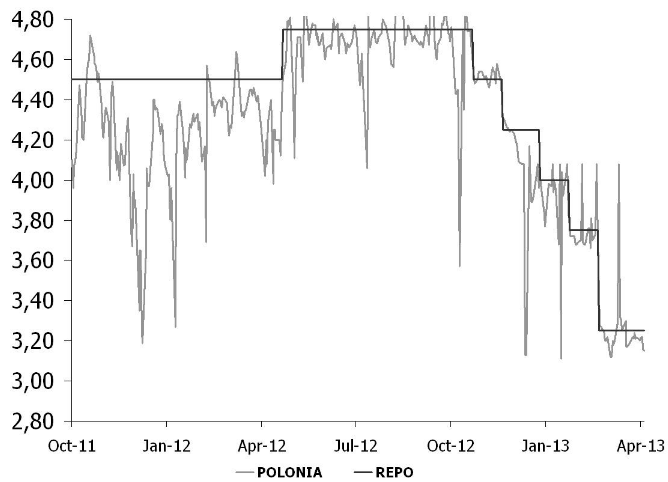
Cheap end of the reserve very likely. Very low demand during today's OMO (123.5 vs 133 bln pln supply) pushed the shortest rates down. Additional OMO is very likely on Tuesday, however taking into account maturity of PS0413 and coupon payments from the rest of the April papers, we believe that very cheap end of the reserve is ahead.

New rates cut cycle? Very weak figures from the local economy supported the bullish trend that has been with us for sometime now. Ultra dove Bratkowski sees room for 100 bps more cuts mentioning even 50 bps as soon as in May. Dove Zielińska-Głębocka sees room for 50-75 bps in a more cautious mode. Winiecki (ultra hawk) thinks that current level is justified and sufficient for the economy to recover. All this shows the scale of disagreement among MPC members. We bet on the scenario in which they will kind of announce the possibility of cut in June. Then they will cut in June and July. Market is pricing 75 bps in 3M time. We think that there is a chance of 25 bps being priced in before May meeting, and 50 bps play in June after no cut in May.









Forex

Tight range. After the strong PLN gains in last week, we have spent the whole week consolidating the move in extremely tight range 4.09/4.13. The Zloty was immune to the worsening macroeconomic data and new rate cut cycle looming on the horizon. We are actually trading water here, which unbeaten appetite for Polish Government bonds still PLN supporting. The range 4.09/4.13 has to be broken to add same more colour.

Vols unchanged. The EURPLN vol curve is unchanged from last week. With 1m EUR/PLN ATM mid fixing today at 6.0%, 3 month 6.5%, 1 year 7.5%. Today there are even less reasons to buy vols, as during last week the gamma hasn't really covered theta bills (realized Vol 1 week with daily hedges was 2.73 % !). The currency spread (deference between USD/PLN and EUR/PLN) was better offered, as well as the skew.

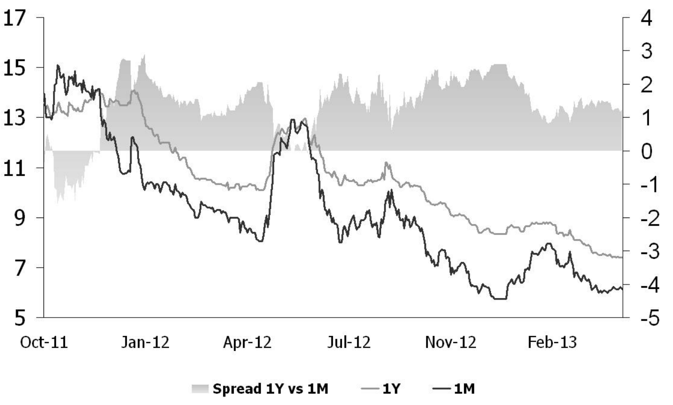
Short-term forecasts

Main supports and resistances
EUR/PLN: 4.0850 / 4.1900
USD/PLN: 3.0500 / 3.3000

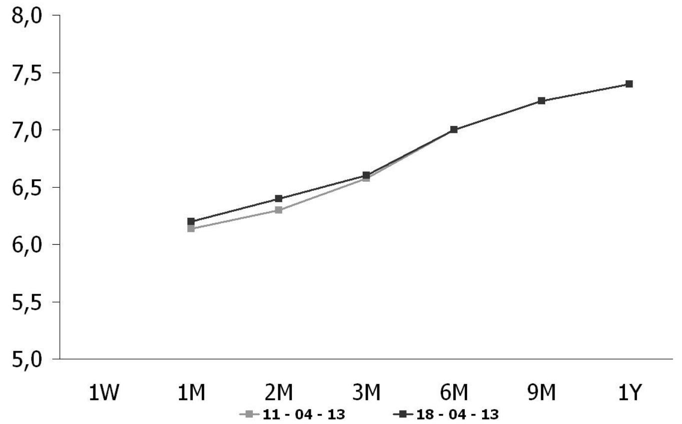
Buy EUR/PLN. Stay aside, this range is far to tight to play on it. There is little or no reason to get involved.

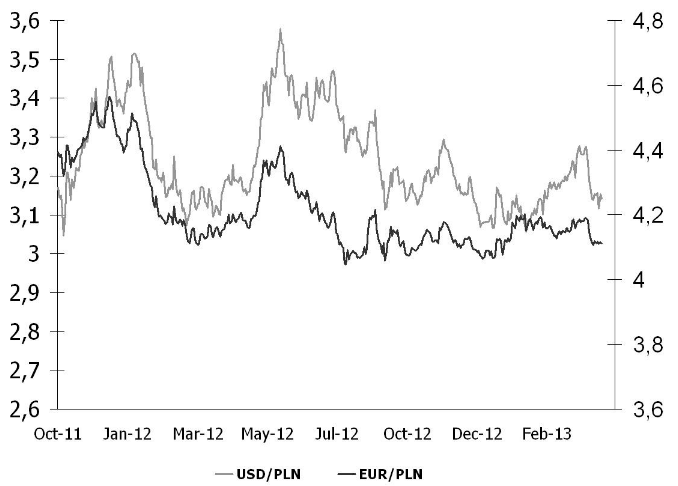
Derivatives. Unchanged. We have changed our selective Vega buying recommendation, to a neutral one. The realized volatility is constantly descending (especially if we look at daily basis). It does not bode well for Vega longs. The vols are cheap, in comparison to the historic ones, but they are quite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

EURPLN volatility



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
4/13/2013	3.04	3.35	3.03	3.25	3.07	3.25	3.21	3.04	2.90	2.86	2.88	2.90
4/14/2013	3.04	3.35	3.03	3.25	3.07	3.25	3.21	3.04	2.90	2.86	2.88	2.90
4/16/2013	3.08	3.35	3.10	3.25	3.10	3.25	3.21	3.01	2.83	2.79	2.83	2.85
4/17/2013	2.98	3.35	2.96	3.25	3.00	3.25	3.18	2.95	2.75	2.72	2.74	2.77
4/18/2013	3.04	3.31	2.99	3.20	3.03	3.20	3.14	2.87	2.69	2.66	2.68	2.71

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
4/13/2013	3.250	3.353	3.292	3.275	3.420	3.351	3.630	3.873
4/14/2013	3.250	3.114	3.263	3.148	3.370	3.270	3.575	3.755
4/16/2013	3.250	2.992	3.218	3.137	3.325	3.237	3.525	3.759
4/17/2013	3.250	2.992	3.218	3.137	3.325	3.237	3.525	3.759
4/18/2013	3.200	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
4/13/2013	6.14	6.53	6.95	7.43	7.43	2.58	0.64
4/14/2013	6.14	6.53	6.95	7.43	7.43	2.58	0.64
4/16/2013	6.23	6.60	7.05	7.40	7.40	2.65	0.71
4/17/2013	6.14	6.60	7.05	7.40	7.40	2.65	0.71
4/18/2013	6.20	6.60	7.00	7.40	7.40	2.65	0.71

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
4/13/2013	4.1200	3.1537	3.3833	3.1821	1.3901	0.1593
4/14/2013	4.1200	3.1537	3.3833	3.1821	1.3901	0.1593
4/16/2013	4.1178	3.1559	3.3872	3.2310	1.3946	0.1591
4/17/2013	4.1097	3.1159	3.3815	3.1722	1.3983	0.1591
4/18/2013	4.1150	3.1529	3.3850	3.2122	1.3846	0.1590

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