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Comment on the upcoming data and forecasts

The first batch of May data comes out next week, starting with developments in the nominal sphere (inflation and M3). We expect inflation to have further moderated on strong decline in fuel prices and modest food price increases. Core inflation has probably increased, though, as low base from the previous year kicked in. Broad money growth has probably slowed down as household deposits become increasingly less attractive with current interest rates, especially compared with other assets (record inflows into mutual funds last month). Another negative contribution comes from high statistical base in other categories such as local governments' deposits.

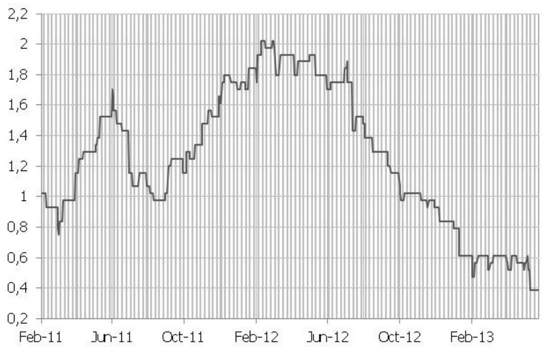
Polish data to watch: June 10rd to June 14th

Publication	Date	Period	BRE	Consensus	Prior
CPI y/y (%)	13.06	May	0.6	0.7	0.8
Core inflation y/y (%)	14.06.	May	1.2	1.2	1.1
M3 y/y (%)	14.06	May	6.5	6.5	7.2

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	-	2500	2.748	4/23/2013
5Y T-bond PS0718	-	4500	3.303	6/6/2013
10Y T-bond DS1023	-	3000	3.290	5/16/2013
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment
No surprises this week (PMI in line with expectations). Next weeks brings the first batch of May data with inflation figures most likely to surprise. The index should remain broadly unchanged over the next weeks, though, as the economy is probably bottoming out.

* 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

- Available data confirm stagnation in H1 2013. External developments (moderate growth in Germany set to come no sooner than at the turn of H1/H2, prolonged recession in the 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 already dipped into negative territory on high uncertainty and 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 revival 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 rate 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”).
- We are in the middle of one of the steepest disinflation phases in Polish history. CPI inflation close to 0% in mid 2013. The possibility for significant undershooting of inflation target in 2013 is our base case.
- Although the MPC began to signal that the end of the easing cycle (again) is near, we believe another cut is still in the pipeline on the basis of weak macroeconomic conditions, persisting low interest rates environment in Europe and low inflation. We expect reference rate to fall to 2.25-2.50%.

Financial markets

- Given our below consensus view on growth, inflation and NBP rates we stay contructive on short-term bonds. Note that NBP may also use uconventional tools to boost banks’ demand for government papers (we believe in such scenario even more after most recent outflow of foreign funds from bond market and FX intervention).
- Ultimately, global recovery (or monetary stimulus withdrawal), rising core yields and higher volatility will adversely affect Polish bonds.
- The ”wall of money” obscured the cyclicality of the Polish currency. This fact was revealed when expectations on QE tapering accelerated and the zloty dynamicaly breached 4.22/25 and broke out of the 1 year range. Although we think that the market probably overshoot the timing of QE tapering, the environment changed towards less zloty-friendly. Therefore we expect a return below 4.20 no sooner than when the economy accelerates visibly (long into H2) or rate cut expectations halt and begin to turn-around (a turn of 2013/2014).

BRE forecasts

	2008	2009	2010	2011	2012	2013 F
GDP y/y (%)	5.1	1.6	3.9	4.5	1.9	1.0
CPI Inflation y/y (average %)	4.3	3.5	2.8	4.2	3.7	0.7
Current account (%GDP)	-5.3	-1.6	-4.5	-4.9	-3.5	-2.5
Unemployment rate (end of period %)	9.5	12.1	12.4	12.5	13.4	13.9
Repo rate (end of period %)	5.00	3.50	3.50	4.50	4.25	2.25

	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.5	2.3	1.3	0.7	0.5	0.6	1.2	1.7
Individual consumption y/y (%)	1.7	1.3	0.2	-0.2	0.0	0.5	1.3	1.9
Public Consumption y/y (%)	-1.0	0.4	1.6	-0.6	-0.5	0.5	0.5	0.5
Investment y/y (%)	6.8	1.4	-1.7	-4.1	-2.0	-4.5	-3.0	-2.5
Inflation rate (% average)	3.9	4.0	3.9	2.9	1.3	0.6	0.2	0.7
Unemployment rate (% eop)	13.3	12.4	12.4	13.4	14.3	13.4	13.3	13.9
NBP repo rate (% eop)	4.50	4.75	4.75	4.25	3.25	2.75	2.25	2.25
Wibor 3M (% eop)	4.94	5.13	4.92	4.11	3.39	2.70	2.45	2.45
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.14	3.19	2.50	2.50	2.50
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.74	3.94	3.40	3.50	3.60
EUR/PLN (eop)	4.15	4.22	4.12	4.08	4.18	4.25	4.20	4.15
USD/PLN (eop)	3.11	3.35	3.20	3.09	3.26	3.33	3.36	3.46

F - forecast

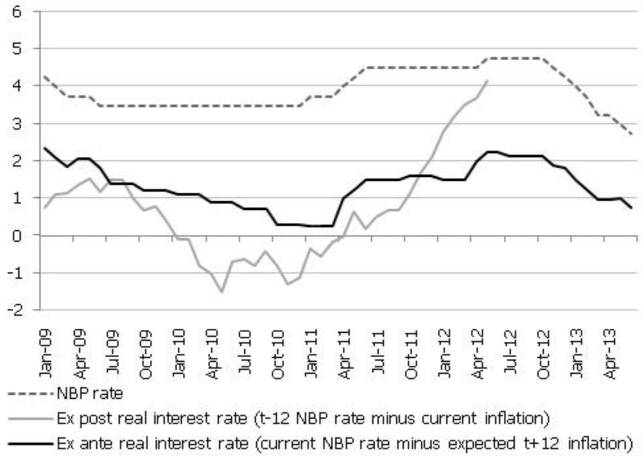
Economics

The MPC cuts rates. More speculation about the end of the cycle.

In line with expectations, the MPC cut rates by 25 bps to a record low of 2.75%. In the descriptive part of its statement, the Council confirmed that the slowdown is on-going (including a hardly optimistic growth structure) and that both current inflation and expected future inflation are falling. Most puzzling was the end of the statement, radically different from last month's document. It states: The Council assesses that monetary policy easing conducted since November 2012 supports economic recovery and limits the risk of inflation running below the NBP target in the medium term. That sentence was later interpreted by M. Belka not as one ending the cycle but rather as reaffirming that it is continued.

The tone of the conference was largely dovish. Governor Belka said that he sees no signs of economic recovery and ridiculed his overly optimistic colleagues. Belka sees inflation dropping even further (pointing at expert forecasts) and stressed the role of domestic factors (and not external ones, such as speculation on QE3 tapering in the US) as decisive for monetary policy. In his view, a rise in core inflation stemming from one-off factors or rising administered prices is not a sign of increasing inflationary pressures. Recent depreciation of the zloty was actually welcomed (no wonder - in a low-inflation and low-growth environment). However, two days later the NBP intervened in the FX market to calm short-term distortions.

Nevertheless, he also provided hints about the "adequate" level of interest rates (we are apparently getting close to it) and the possibility of setting a firm and clear direction for monetary policy in July (by the time of the next meeting, new NBP staff projections will have become available). As for the latter - this statement was interpreted as the announcement of the end of the easing cycle and triggered a dynamic correction in fixed income markets - yields rose across the whole curve. As for the former - Belka stated that the Council is interested in keeping ex ante real interest rates (i.e. the difference between current policy rate and expected inflation in 12 months - see the graph below) above zero. Hence current consensus on mid-2014 inflation is ca. 2%, there is still room to go on cutting.

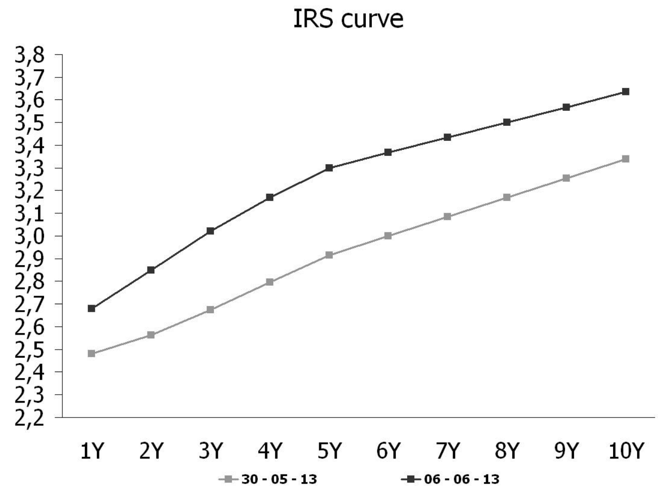


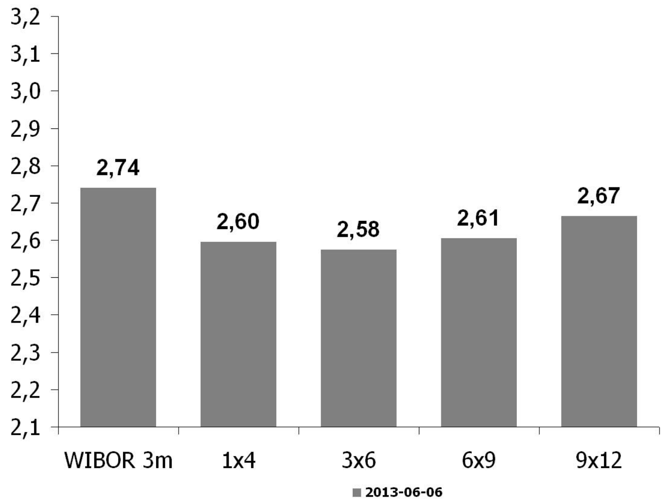
In our view, the MPC will cut rates in July. We see the intervention on FX market as a way to correct only short-term movements and not a change in the Council's stance towards the interest rate. Would expectations of further cuts evaporate after another cut and a strong statement in July? Not necessarily so. Low inflation might continue to stimulate expectations for a cut in September. This (rate cut in September) is not our baseline scenario: even current levels of interest rates are highly stimulative and the Council might prove to be reluctant to extend the cycle for the second half of the year (decisions are now being made with a 5:5 ratio of votes).

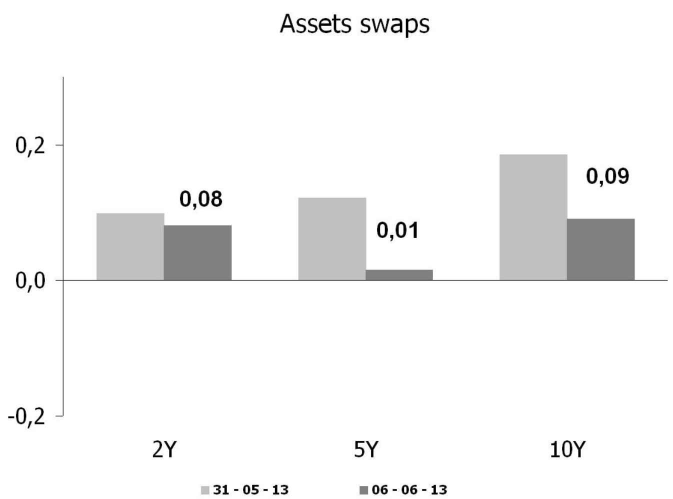
Fixed income

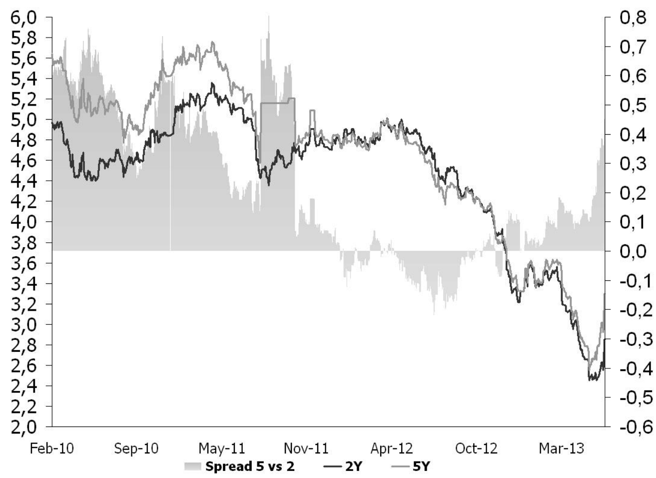
New, better (?) curve

So, we had another very interesting week on the FI market. After MPC's decision (-25bp rate cut) and comments about 'strong statement next month' whole Curve went up by some 30bps. Wibors are not going down anymore and that is why our pay 9x12FRA works so well currently. We saw significant flows to sell 2-5 year bonds from foreign investors but we believe this is only temporary panic. Also, 5 year bond auction was really strong. Our economy is still in quite a bad shape and we expect the repo rate to stay low for a long time. That is why we like to receive belly of the curve at current levels.



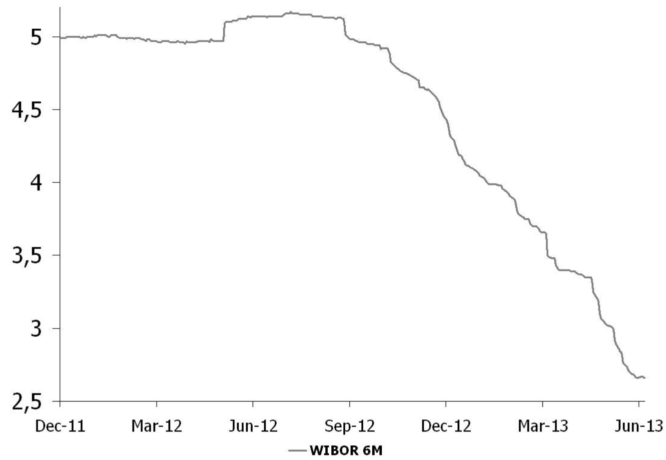




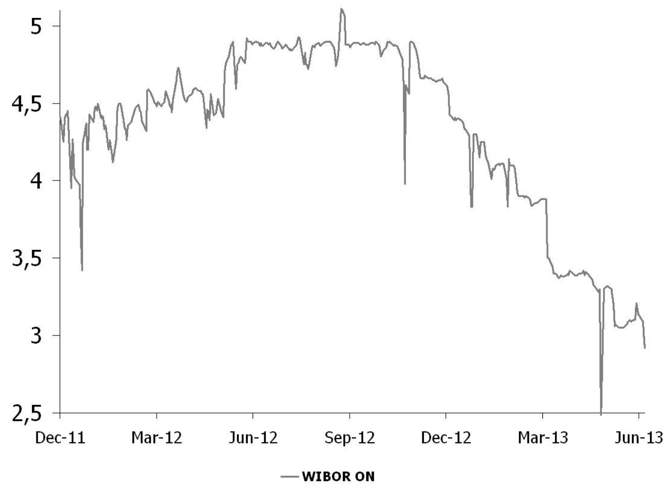


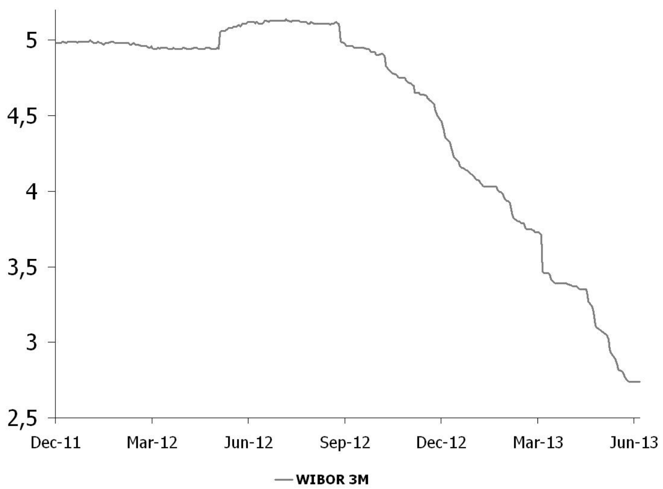
Money market

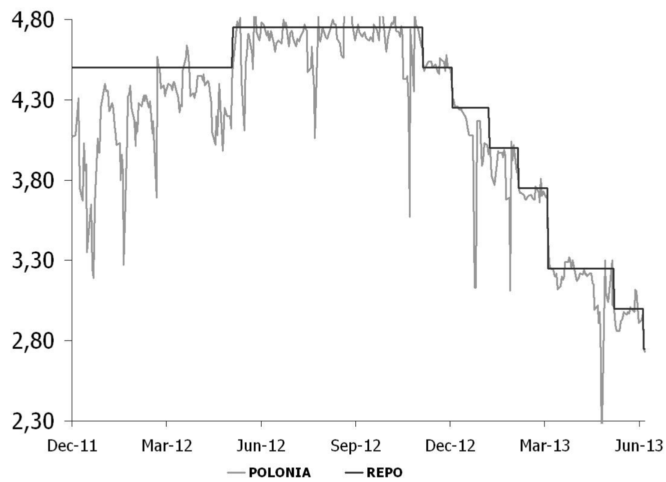
25 bps cut, 25 expected plus end of the cycle? Bit lower demand for money bills (127.3 vs 128,5 billion pln), however it should not affect the shortest rates next week. 3M and 6M wibor 1 tick up, the direction have not seen for a long time. It was caused by the global factors affecting polish assets, nonetheless the rates cut cycle is near to its end and the upward-sloping curve is inevitable. But first flattener of course. It is a bit too early to judge whether it was a one off or the start of a trend. Let us bear in minds that we have really nasty local figures ahead and probably not the best cpi projection one could imagine. 25 bps cut in July is almost certain. 50 bps cut has nonzero probability that may grow after the figures if not paired off by global factors.



Global factors ruthless for polish assets Longer terms under huge pressure despite the 25 bps cut and quite dovish conference. Market focused on the near end of the cycle wording by MPC, QE easing wording by FED and the Turkish turmoil. The two latter started risk aversion to EM assets in general. All in all rates went up by 20-30 bps across the curve on one day just to price off overestimated cuts expectations, plus pressure is sustained by global factors and it does not look any better soon. First figure is CPI on Thursday. We should see 0.6, then negative IO, PPI, employment and retail sales. Is it enough to strengthen the front end?



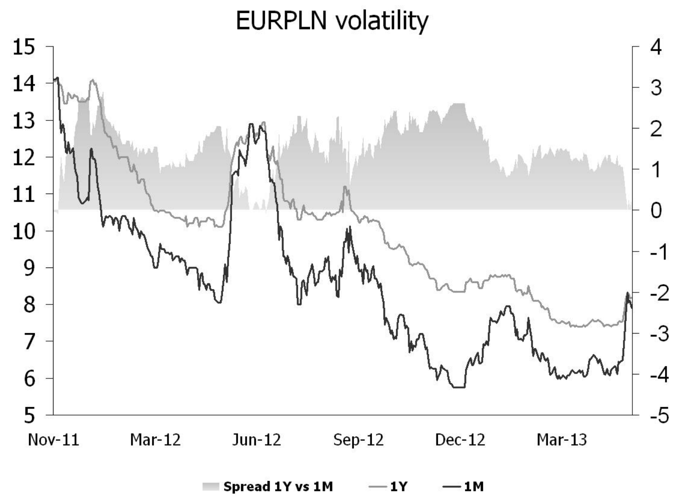




Forex

Volatility is back From quasi-safe-heaven to regular emerging asset, that is how PLN relocated after only a thread of potential end of QE. What started like a flirt with a higher end of the range (EUR/PLN 4.20), now looks really gloomy. With outflow from POLBONDS instead of an inflow, PLN is at the mercy of global sentiment. We should get prepared for increased volatility and possibly much weaker PLN in weeks ahead. We have written the above before the Central Bank action. In addition that the Polish central bank has intervened on the market selling EURPLN and pushing the EUR/PLN from 4.31 to 4.26... Well, that took us completely off-guard, a bit hysteric move in our view.

Vols higher The realized volatility on 1 week spiked, the Gamma was bid higher and higher. 1 month EUR/PLN ATM mid is now 9.25% versus 8.5% last week, 3 months 9% from 8.3%, 1 year 9% (8.4% last Friday). The skew was bid with 3 month R/R 25 D paid at 2.5% and 1 year 25 R/R same delta was paid 3%. The currency spread is relatively calm, unchanged or tic lower across the curve as EUR/USD uptrend is making USD/PLN vols bit less attractive. After NBP intervention the vols were given with 1 month sold at 9%.

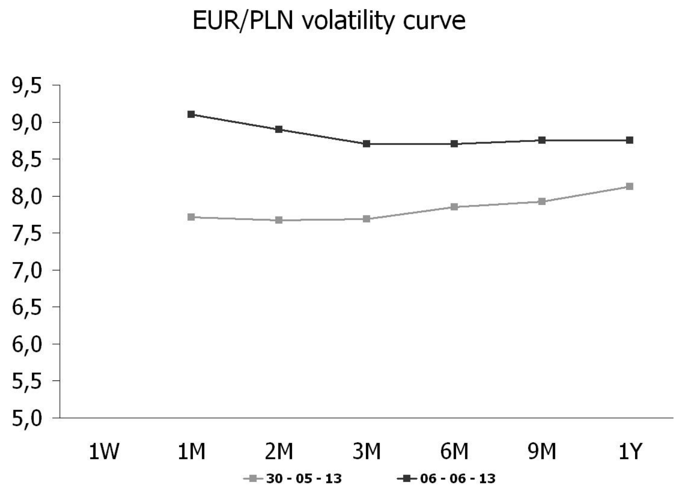


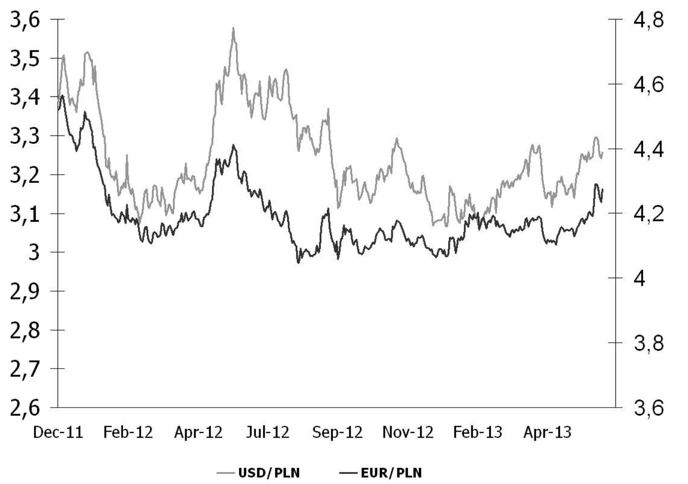
Short-term forecasts

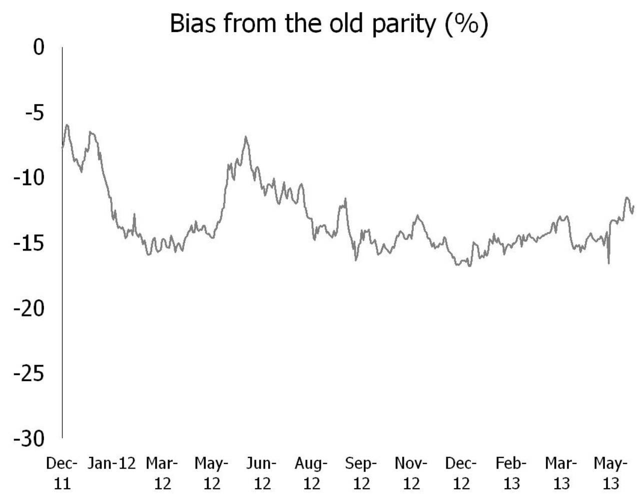
Main supports and resistances
EUR/PLN: 4.2500 / 4.4200
USD/PLN: 3.1500 / 3.4500

BUY EUR/PLN on dips. The volatility is ruling now, so it is better to cut trading position by half and double the stop loss. A few figures left/right might simply a noise. Ideally, we would like to buy EUR/PLN at 4.25/4.27 level with stops below 4.20 and 4.40 target. We think buying EUR/PLN in dips is the name of the game now. Thanks to NBP Intervention we bought EUR/PLN at our dreamed level.

Derivatives. We are already long Vega in EUR/PLN and looking forward to add on dips. We think volatility is back for good. Of course like always in such environment, the spreads are now 3 times wider, and liquidity is changing from bad to worse. The NBP intervention will stop the vol rise only temporary.







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
6/2/2013	2.59	2.74	2.49	2.56	2.48	2.55	2.62	2.49	2.43	2.46	2.54	2.49
6/3/2013	2.53	2.74	2.50	2.57	2.48	2.55	2.60	2.45	2.42	2.41	2.50	2.44
6/4/2013	2.58	2.74	2.51	2.57	2.50	2.55	2.54	2.39	2.35	2.35	2.41	2.38
6/5/2013	2.54	2.74	2.51	2.56	2.50	2.55	2.57	2.47	2.45	2.47	2.53	2.50
6/6/2013	2.54	2.74	2.56	2.56	2.59	2.55	2.60	2.58	2.61	2.67	2.79	2.66

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
6/2/2013	2.550	3.353	3.292	3.275	3.420	3.351	3.630	3.873
6/3/2013	2.550	3.114	3.263	3.148	3.370	3.270	3.575	3.755
6/4/2013	2.550	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/5/2013	2.550	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/6/2013	2.550	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
6/2/2013	8.33	8.28	8.23	8.33	8.33	2.82	0.73
6/3/2013	8.05	8.15	8.20	8.30	8.30	2.82	0.73
6/4/2013	8.10	8.00	8.05	8.16	8.16	2.79	0.73
6/5/2013	7.90	7.95	8.08	8.18	8.18	2.77	0.73
6/6/2013	9.10	8.70	8.70	8.75	8.75	2.97	0.73

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/2/2013	4.2902	3.2953	3.4569	3.2816	1.4465	0.1666
6/3/2013	4.2786	3.2865	3.4335	3.2813	1.4455	0.1663
6/4/2013	4.2520	3.2524	3.4259	3.2432	1.4520	0.1650
6/5/2013	4.2349	3.2421	3.4168	3.2445	1.4421	0.1642
6/6/2013	4.2742	3.2564	3.4602	3.2854	1.4409	0.1658

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