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Comment on the upcoming data and forecasts

Next week brings key releases from the real sphere. On Monday, the NBP will publish latest current account statistics. We expect it to post a surplus due to high interest payments and large EU transfers, as well as a surplus in trade (already confirmed by trade data published by GUS earlier this week). Labor market data (Tuesday) are set to remain stable and boring: wage growth oscillates (along with working days) around trend-derived value of 2.5% and employment could have stabilized - the y/y dynamics might have ticked upwards). Headlines from the industrial sector (data published on Wednesday) will paint a grim picture: on-going producer price deflation and a y/y decline in real output. The former is exacerbated by stable commodity prices and exchange rates, as well as high statistical base. The decline in output is due to negative difference in working days and their arrangement (two "extended weekends" in May) as well as base effects in food and beverages production. Lastly, the Minutes from the last MPC meeting will be published on Thursday.)

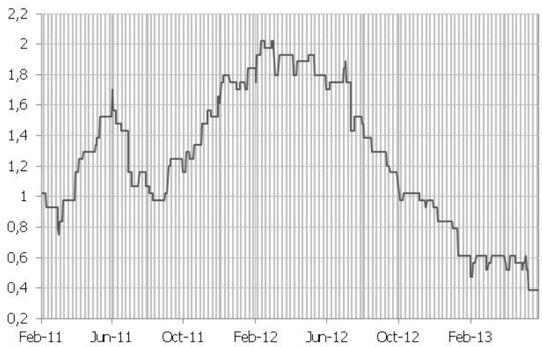
Polish data to watch: June 17th to June 21st

Publication	Date	Period	BRE	Consensus	Prior
Current account (mio EUR)	17.06	Apr	108	-153	-200
Budget performance YTD (%)	17.06	May			89.3
Wages y/y (%)	18.06	May	2.3	2.6	3.0
Employment y/y (%)	18.06	May	-0.9	-1.0	-1.0
Industrial output y/y (%)	19.06	May	-4.1	-1.9	2.7
PPI y/y (%)	19.06	May	-3	-2.5	-2.0

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
CPI turned out to be a big negative surprise. It is therefore no wonder that the index dipped and reached new lows. Next weeks brings crucial data from the real sphere - due to specific factors adversely influencing economic activity in May, negative surprises in industrial data are probable.

* 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 (no more than 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") and PM Tusk considers it more likely than lack thereof.
- 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	0.8
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	2.50

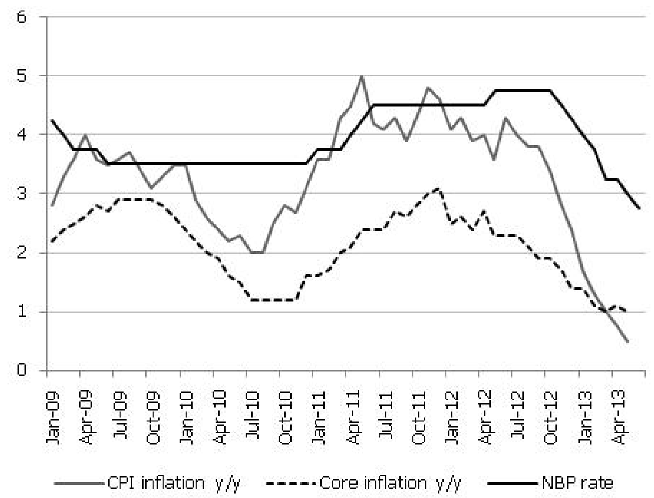
	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.5	2.3	1.3	0.7	0.5	0.6	1.2	1.7
Individual consumption y/y (%)	1.7	1.3	0.2	-0.2	0.0	0.5	1.3	1.9
Public Consumption y/y (%)	-1.0	0.4	1.6	-0.6	-0.5	0.5	0.5	0.5
Investment y/y (%)	6.8	1.4	-1.7	-4.1	-2.0	-4.5	-3.0	-2.5
Inflation rate (% average)	3.9	4.0	3.9	2.9	1.3	0.6	0.2	0.9
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	2.50	2.50
Wibor 3M (% eop)	4.94	5.13	4.92	4.11	3.39	2.70	2.70	2.70
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.14	3.19	2.70	2.60	2.60
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.74	3.94	3.50	3.60	3.70
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

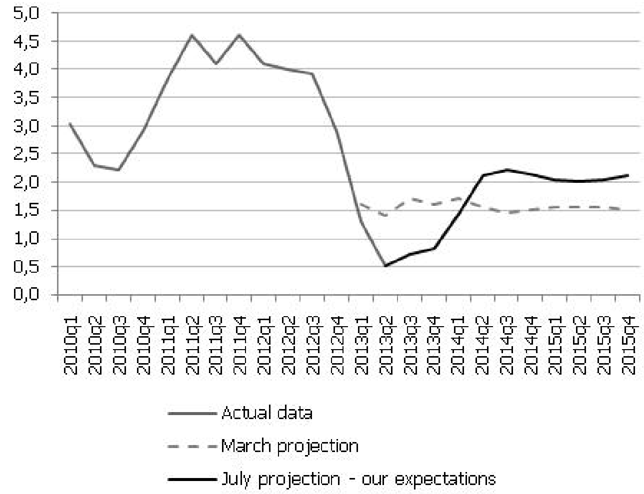
Poland: 4th lowest inflation reading in history

Inflation in May came out at 0.5% y/y (a tad below our forecast of 0.6% and significantly below market consensus of 0.7%). The decline is the aftermath of a large decline in fuel prices (-4.0% m/m), benign behavior of food prices (+0.8% m/m) and drops recorded in telecommunications (telephone bills). Core inflation dropped from 1.1% y/y to 1.0% y/y.



Is it the trough of inflation? We think it is not yet the case. Next month is likely to bring somewhat less benign food prices (seasonal effects postponed to June) and a minor, upward correction of fuel prices. However, mobile phone prices may go down, as the other operators will be forced to adjust their price lists, and base effects (honestly, quite substantial) give a lot of space for lower reading (close to 0.2%).

Debt market reaction was positive, yield curves shifted down. We think that this minor divergence of inflation (NBP expected that in no month inflation would be lower than 0.6%) begins the series of surprises (the subsequent ones are connected with the real sphere, and the icing will be provided by the poor inflation figures) that will encourage MPC to cut rates despite recent NBP's FX intervention. We know the official motives of NBP when it decided to interfere with the exchange rate. However, we are also well aware that more hawkish members are set to raise objections concerning the inconsistency of rate cuts and EUR selling - poor figures are likely to cement the more dovish camp enough to force through a standard cut (25bps) at July's meeting. If industrial output and retail sales come out firmly in negative territory, expectations of a 50 bps cut are certain to materialize.



Furthermore, by July the MPC will be provided with the results of the latest inflation projection. Given available information, we can try to guess as to the direction and the shape of inflation path in the new report. First, price developments in recent months have already pushed it even lower in 2013 and forced the NBP to revise its forecasts downwards for this year. On the other hand, the new projection will factor in additional 100 bps of rate cuts as well as the fact that VAT rates will not be lowered in 2014 (as it was assumed in the March projection). All in all, a rise in inflation in the second half of the year, as well as in 2014 will be clear and unambiguous. The shape of the curve will itself be a clear signal to the market that this indeed is the end of monetary easing in Poland.

In our view, NBP's target will not however be reached within the forecast horizon (our guesstimate is that projected CPI might at best reach 2.1-2.2% y/y in late 2014). This will boost the case for another cut - although 25 bps is our baseline scenario, we cannot rule out a larger one (50 bps is possible). Having done that, the Council is likely to end the easing cycle and move to a neutral stance, as 225-250 bps of cumulative cuts will be regarded as sufficient for inflation to return to target amid higher growth. As the economy slowly recovers in H2 - we believe that limited fiscal stimulation (or at least the end of austerity) in Europe will strenghten growth and offer additional boost to the Polish economy - easing expectations will finally end.

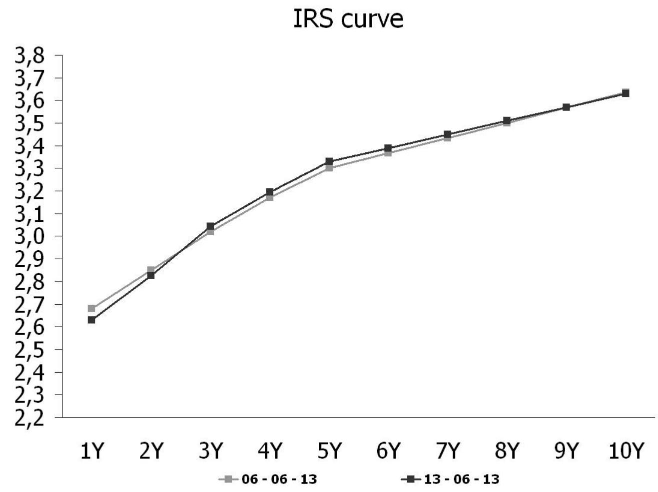
Fixed income

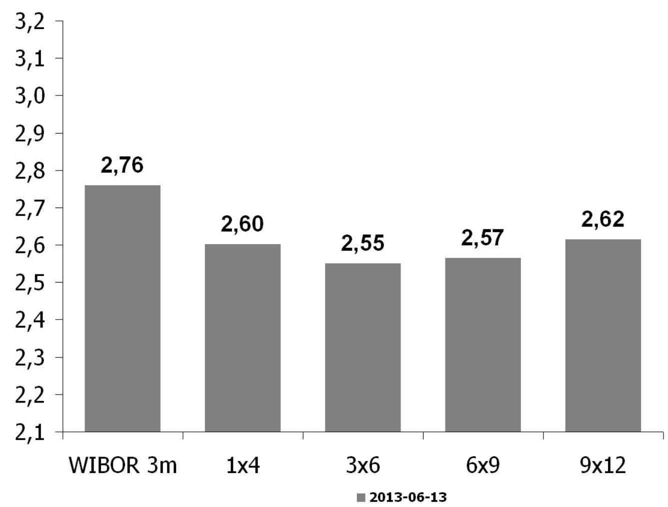
Stress test

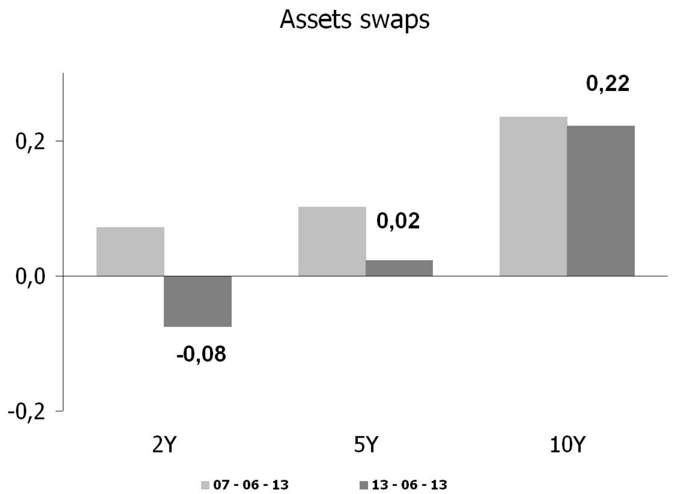
Last week the Polish FI market remained under huge paying pressure on a global outlook. The massive outflow from domestic assets pushed the yield curve up to new highs trading 2y at 3.14% and 5y at 3.60%. The price of the benchmark 10y Treasury bond DS1023 collapsed under 100.00 yielding over 4% on Tuesday afternoon. Surprisingly, Polish central bank's multiple interventions on the FX market late Friday afternoon turned out to be only a temporary cure. It sparked a new wave of a more aggressive sell-off as markets had found that move as sign that situation might have gone out of control. On the other hand, some of the domestic players believed that such a massive move in rates might give a good opportunity to receive before the whole set of quite bullish domestic macro data this month is shown to public. The CPI release at 0.5% y/y, the first of a set, had changed the mood on the market definitely. The yield curve dropped back by 20-30 bp from its previous tops having been supported by a turn-back on core markets.

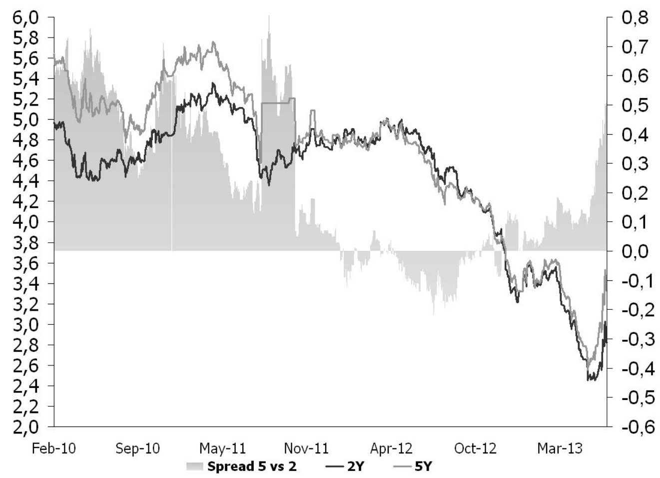
We tend to keep our receivers up to 2Y to the next MPC meeting as we believe the next data are likely to show the economy still doing bad. The 25bp cut on a July meeting seems to be a done-deal scenario but we also recognize the risk that another 25bp would be very likely played by the market before September's meeting, especially if the CPI reading in August shows negative values y/y.

And the last thoughts... As we look back at the last two weeks of the market liquidity, we can easily learn a simple lesson. That was a stress test of what might happen in Autumn when we face the real outflow from all of the speculation bubbles the cheap money could have bought for the last year. Fortunately, we are ahead of summer holidays, so enjoy them.





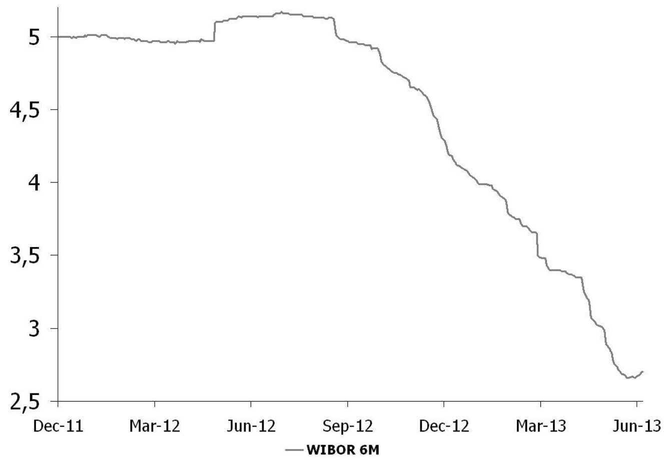


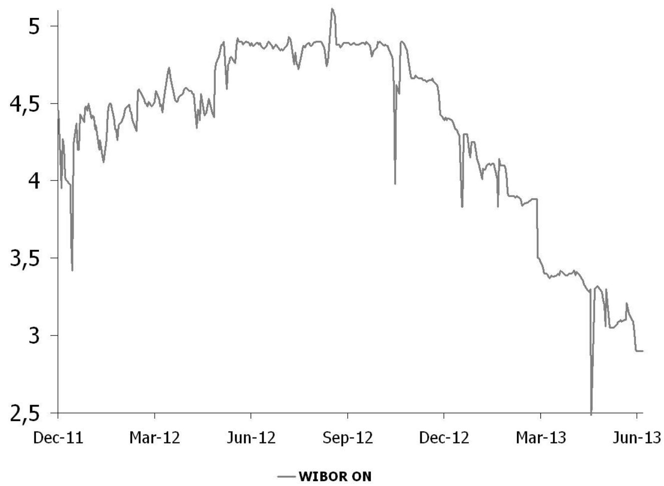


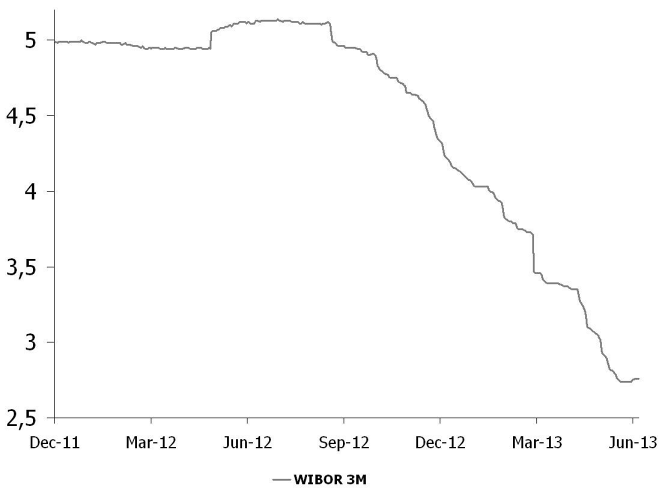
Money market

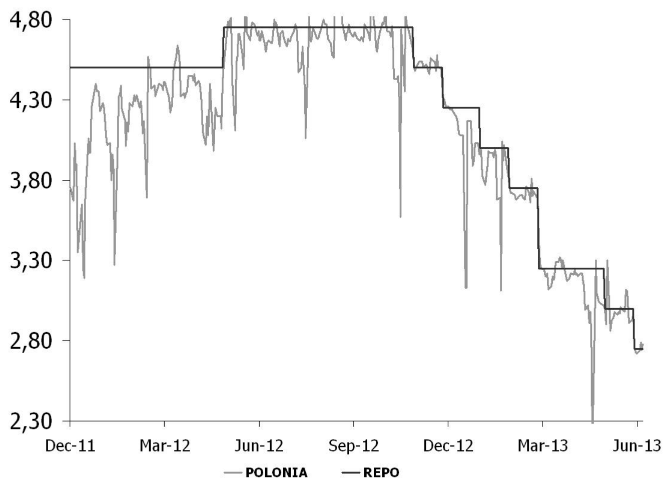
Additional OMO likely Two scenarios for the cost of carry next week. 1. Very low shortest rates since today's OMO was significantly underbid (116,6 vs 123,5 bln pln). 2. Additional OMO on Tuesday and rates back to main rate level. We think the latter is much more probable.

Figures support rates cut expectations. Bearish for longer rates till last Friday. It looked like hedge fund managers were limiting emerging markets risk due to Turkish turmoil. It was locally stopped by the fx intervention and then the trend was turned by lower then expected cpi figure (0.5 vs 0.8). We still have key figures ahead and it should strongly support July cut. We bet on 25 bps plus end of the cycle announcement. We like paying wibor (FRA) and selling polonia (ois). We also bid short bonds (1-3 year sector) on dips. Our scenario would be under pressure if global situation worsens (further asset reallocation from EM plus tapering the QE sooner).









Forex

Volatility is back This week EUR/PLN has dropped to 4.2040 from its YTD high (4.3250) hit last week, a day before the NBP intervention (selling EUR/PLN). The government-owned BGK Bank was pretty active all week selling hard currency against the PLN. It's not the regular NBP intervention (like last Friday), but merely the MF exchanging its EUR on the market. The improved global sentiment, renewed appetite for Polish bonds were the last elements in the Zloty rally. The question is, will they last? Well, the key is in Bernake's speech scheduled next week, and the performance of core market bonds. Our local factors are of minor importance, even though we are most likely going to have fresh hopes for rate cuts which would translate into bigger demand for bonds.

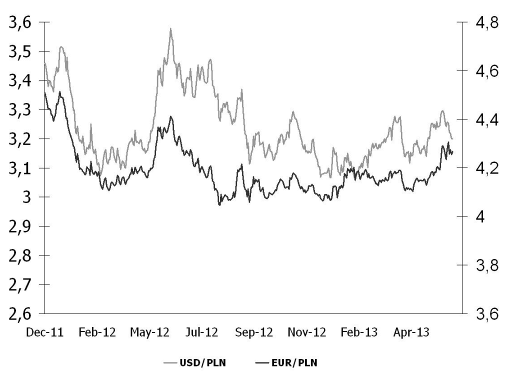
The vol of the vol The volatility of the volatility is something we haven't seen for months already and now seems to be back in style. One should check its Volga positions to avoid future surprises. The 1 EUR/PLN 1 year ATM was paid and bid on at 9% last week, only to fix 8.5% this week. 3 month EUR/PLN ATM mid is now (Friday 14th July) 8.4% (0.8% lower) and 1 month is 8.3 % (1% lower). The skew was better offered and the currency spread (difference USD/PLN minus EUR/PLN) was sliding... The liquidity is poor but better while vols are decreasing then the other way around.

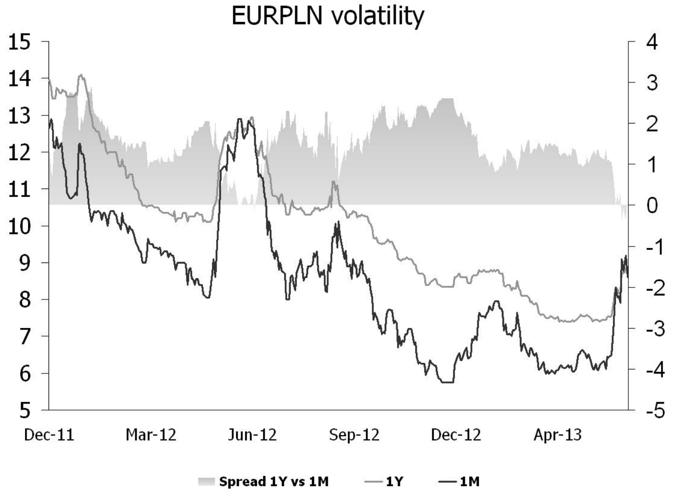
Short-term forecasts

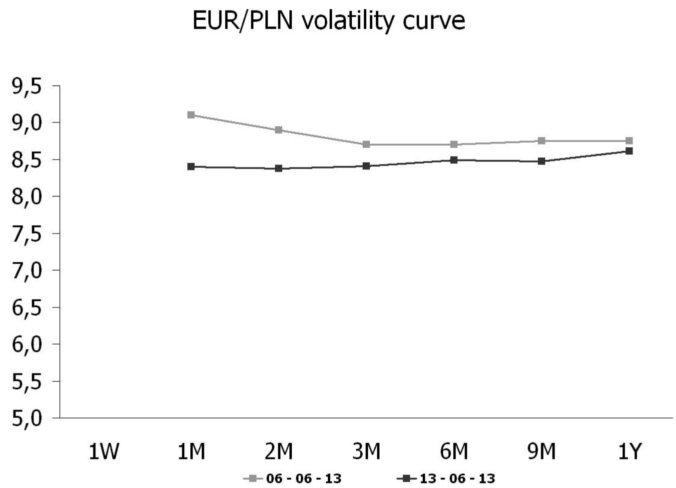
Main supports and resistances
EUR/PLN: 4.1800 / 4.3200
USD/PLN: 3.1000 / 3.3000

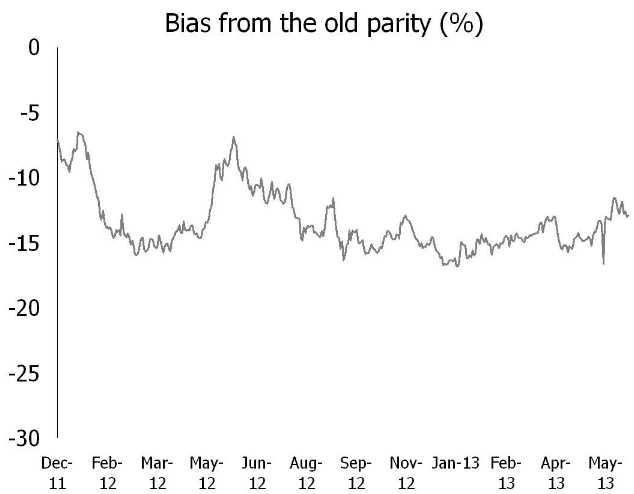
BUY EUR/PLN on dips. Last week long we liquidated at 4.2850. Now long EUR/PLN at 4.2170 ready to add at 4.1900 with a stop below 4.1800. Let's face it, NBP or BGK are not able to stop the PLN losses in case the global sentiment turns sour again. And it will, because even if the low rates will continue in US, all the emerging world is an addict to QE. If it stops or even slows, we will have risk off again.

Derivatives. We are already long Vega in EUR/PLN and looking forward to add on dips. We think volatility is back for good. The next week FED is The Event to be long Gamma, but in general our preferred tenors are in the backend. The dips are providing good buying opportunity. We assume that lower systematic liquidity (without or with smaller US QE) will raise the volatility in all asset classes, FX vols being no exception.









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
6/7/2013	2.59	2.75	2.56	2.57	2.60	2.57	2.62	2.60	2.60	2.63	2.73	2.67
6/10/2013	2.61	2.76	2.59	2.58	2.67	2.58	2.67	2.66	2.68	2.79	2.95	2.77
6/11/2013	2.65	2.76	2.66	2.59	2.75	2.59	2.70	2.68	2.75	2.87	3.06	2.85
6/12/2013	2.67	2.76	2.67	2.60	2.74	2.59	2.66	2.65	2.68	2.73	2.88	2.77
6/13/2013	2.63	2.76	2.63	2.60	2.70	2.59	2.60	2.55	2.57	2.62	2.73	2.63

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
6/7/2013	2.570	3.353	3.292	3.275	3.420	3.351	3.630	3.873
6/10/2013	2.580	3.114	3.263	3.148	3.370	3.270	3.575	3.755
6/11/2013	2.590	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/12/2013	2.590	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/13/2013	2.590	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
6/7/2013	8.78	8.58	8.58	8.70	8.70	2.88	0.73
6/10/2013	9.00	8.58	8.73	8.75	8.75	2.88	0.73
6/11/2013	9.20	8.70	8.75	8.85	8.85	2.91	0.73
6/12/2013	8.60	8.61	8.63	8.75	8.75	2.71	0.65
6/13/2013	8.40	8.41	8.49	8.61	8.61	2.70	0.65

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/7/2013	4.3061	3.2545	3.4993	3.3744	1.4517	0.1679
6/10/2013	4.2571	3.2210	3.4374	3.2628	1.4330	0.1667
6/11/2013	4.2756	3.2201	3.4591	3.2977	1.4248	0.1671
6/12/2013	4.2555	3.2002	3.4548	3.3100	1.4325	0.1663
6/13/2013	4.2685	3.2000	3.4775	3.3907	1.4429	0.1668

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