BRE BANK SA

POLISH WEEKLY REVIEW

June 21, 2013

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Comment on the upcoming data and forecasts

The last part of May data comes out on Tuesday - the Statistical Bulletin along with retail sales and unemployment data. We expect retail sales to have fallen in annual terms on working day and calendar effects, high statistical base in ”Cars” and ”Other” categories, as well as a steep fall in fuel prices. The Ministry of Labor and Social Policy estimates that seasonally unadjusted unemployment rate dropped to 13.5% which validates our below-consensus forecast. On Friday the NBP will publish two additional pieces of data: inflation expectations and revised balance of payments statistics for the first quarter. As for the former, we expect another drop in line with recent disinflation. As for the latter we expect the current account deficit to have been revised upwards due to higher imports - monthly statistics were somewhat inconsistent with other data from the economy. Please note, however, that what is logical is not always obvious in case of BoP statistics.

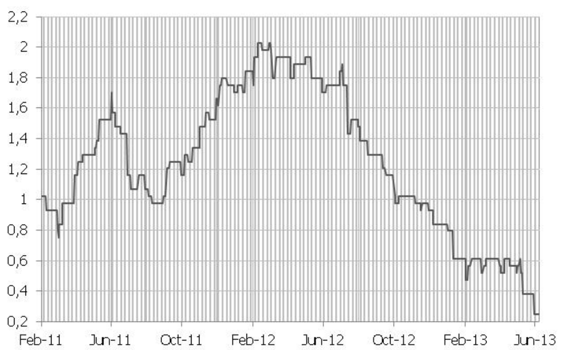
Polish data to watch: June 24th to June 28st

Publication	Date	Period	BRE	Consensus	Prior
Retail sales y/y (%)	25.06	May	-1.2	0.0	-0.2
Unemployment rate (%)	25.06	May	13.6	13.7	14.0
NBP inflation expectations (%)	28.06	Jun	0.6	0.7	0.9
Current account (mio EUR)	28.06	Q1	-3200	-2645	-3477

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 time, surprise index stays unchanged. Two figures come out next week - retail sales (could surprise on the downside - see our preview of incoming data) and unemployment rate (a positive surprise is very likely).

* 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 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 it is coming to an end of the easing cycle (again), we believe another cut in July is still in the pipeline on the basis of the new inflation projection and the inflow of weak macroeconomic data - FX intervention and the Fed (QE tapering) are not going to be an obstacle. July's cut is set to finally conclude the cycle.

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 and liquidity withdrawal) and rising core yields will adversely affect Polish bonds. Fed induced higher volatility has already been doing its job, especially on the long end.
- 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	2.70	2.80
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.74	3.94	4.00	4.15	4.30
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

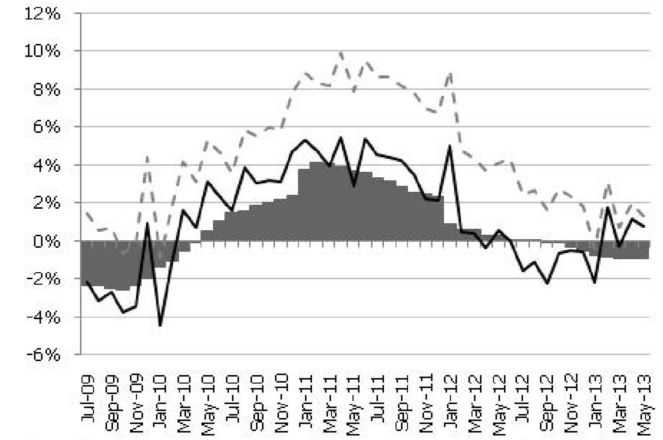
Economics

Disinflation continues, real sphere weak enough to trigger the last cut in July

The recent stream of data confirmed that disinflation continues, not only on the consumer's side (about which we learned two weeks ago) but also in terms of producer prices. Deceleration of prices is proceeding in environment of stabilizing labor market (bottoming out in terms of annual growth) and falling industrial output. Along with inflation projection which will be probably tailored in such a way that a final cut would be enough to bring inflation to target in mid-term perspective, the data provide a good support for a rate cut in July and it is set to be the final one in this cycle. We think that the recent FX intervention and Fed's (conditional) announcement of QE tapering are not an obstacle for the cut.

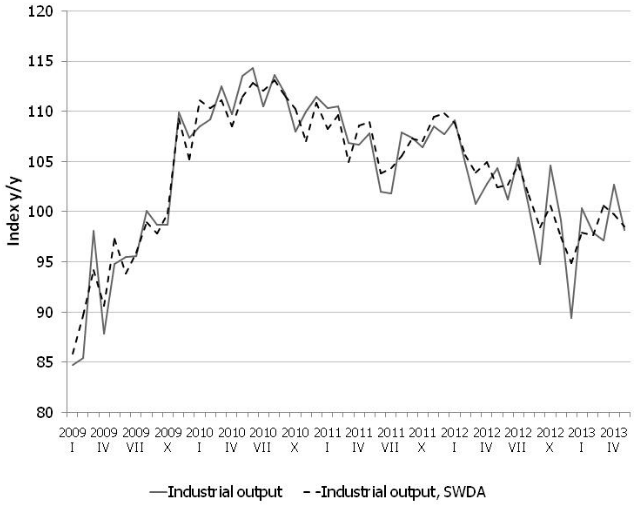
As usual we summarize our thoughts on recent publications.

Labor market in stagnation. Employment in the enterprise sector was down 0.9% year on year. The good news is that employment stabilized its monthly growth around zero (much better than several-thousand drops recorded in recent months). Although this time the good result was most likely propelled by seasonal shifts between April and May, the labor market is by all means stabilizing and various business tendency indicators (e.g. PMI employment component) suggest it is high time to witness a turnaround. Therefore, May reading was possibly the lowest in the cycle.



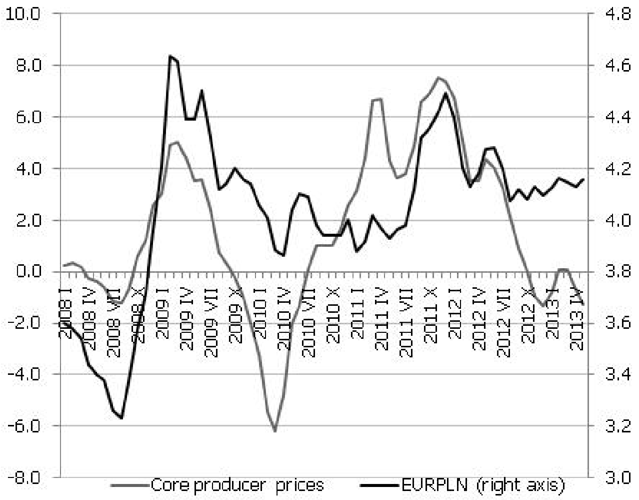
Wage growth declined from 3.0% y/y to 2.3% partly due to calendar effects. Nevertheless, this is broadly consistent with recent trends. Since wages are significantly lagging in the business cycle, we do not expect any substantial improvement in the coming months, even if our baseline scenario (a rebound in economic growth in the second half of the year) materializes. Polish labor market is set to remain an employers' market which results from labor-supply dynamics as well as legal and institutional changes (recent amendments to the Labor Code). The pressure to reduce labor costs will stay with us for quarters, if not for years, as Poland will face increasingly fierce price competition with peripheral Eurozone countries (internal devaluation and a rise in exports). This also suggests that inflationary pressures will come only from food and commodities and changes in administered prices.

Industrial output fell by 1.8% y/y. In seasonally adjusted terms, IO fell by 1.5% (-0.3% y/y in April) - this paints an even grimmer picture than the headline. Output fell due to unfavorable difference in working days and high statistical base from last year (a spike in the production of food and beverages before Euro 2012). In our view, seasonally adjusted indicators might be biased by long weekends (painfully difficult to grasp for algorithms). Therefore, at first sight, the data bear an impression of a poor figure. But when we add the uncertainty concerning the algorithm of seasonally adjustment and substantial, negative base effect (food processing from 2012) the figure may not be as bad as it seems. We think that the MPC is going to acknowledge the first interpretation, though.



Output fell in 18 out of 34 sections, mostly in exports-oriented ones (machinery and equipment, metals, computers) which contradicts gov. Belka's suggestions of a rebound in exports (Polish trade surpluses are due to weak imports!). On the other hand, car production increased - here the trough has probably already happened. Data from Germany and euro-zone peripheries (where the age of unconditional austerity is over) indicate that Polish industry could pick up as well. In the coming months the slow recovery in domestic demand (including consumption) should provide additional boost.

Producer prices dropped by 2.5% y/y. Interestingly, it is the lowest reading in the series. As headline figure is often distorted by exogenous prices, we like to look at price growth in manufacturing alone and excluding prices in oil and coal processing (that is how core producer prices arise). This series is in a downward trend (see the graph)and has recently become immune to changes in exchange rates. There are two explanations: i) either recent exchange rate movements were too small (in this case June will be a good natural experiment), or ii) competitive forces are so strong that enterprises are forced to cut prices (it is a proof that the slowdown is indeed severe). We think it is the latter which matters most at the moment. However, as base effects vanish in the months to come, producer price dynamics will be creeping higher, starting from June.



Construction output fell by 27.6% y/y (seasonally adjusted - 27.1%) - it is probably the deepest drop in history. This happened partly due to unfavorable difference in working days but the prime suspect is very high statistical base from last year (preparations for Euro 2012). In the coming months YoY dynamics will slowly pick up but it will not impress anyone - we are likely to see the first growth in December (sic!). Investment activity has merely stabilized and is unlikely to accelerate this year. Next year will bring new funding from the EU and the central government (first tenders have already been announced). Signs of recovery are yet to be spotted in housing - starts and permits remain at very low levels.

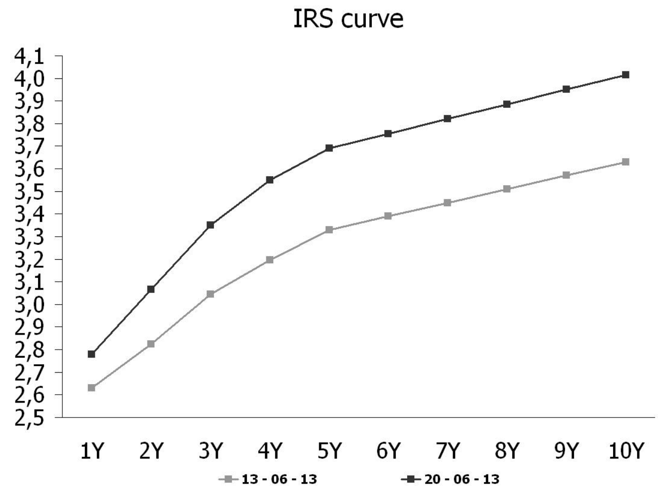
Fixed income

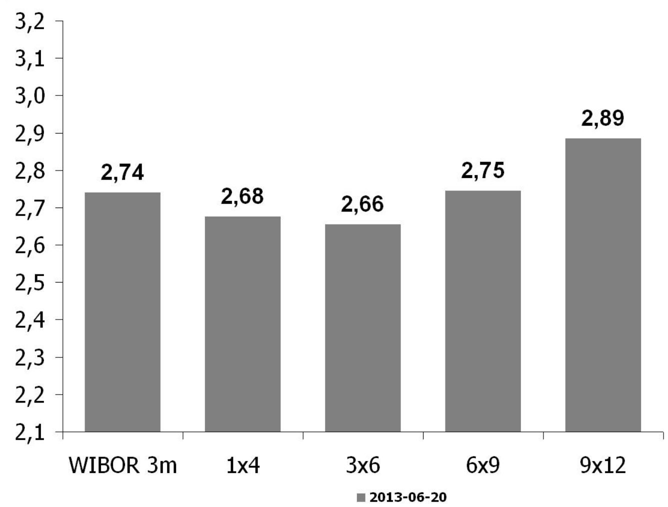
New trend?

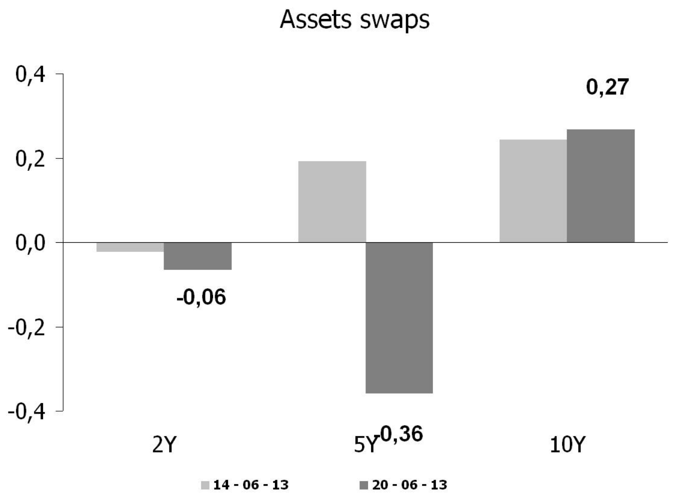
This week the FI market was under huge impact of Fed's comment about possible stimulus withdrawal. 10 year bonds yields soared almost 40bp in one day, but we saw decent buying interest on new levels. We also saw new highs on 2 and 5 year IRS - 3.15 and 3.80, respectively. Is it a new trend on bond yields?

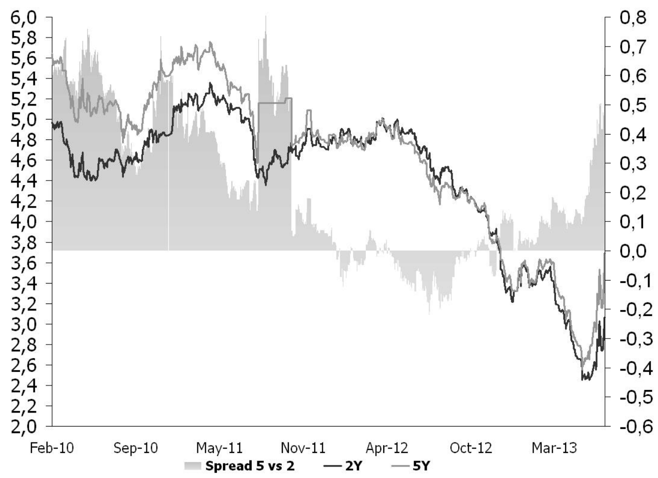
Currency is relatively stable, with only one NBP intervention 2 weeks ago. Polish fiscal side is far from perfect, but it is not so bad compared to other countries in Europe, and we don't expect terrible news from this side in coming weeks. GDP growth and CPI are on lowest levels in recent years. There is a possibility of QE tapering, but market has been "trading on this news" for more than month now. With expectations for a rate cut this month and still weak data incoming in next weeks, we feel that yields on 2-3 year bonds are very attractive now. Current price levels are a result of stop/losses and panic on the market. 3.25% is reasonable level considering overliquid cash market, repo rate and recent market movement.

This week's recommendation: Buy PS1016 at current level (104.60).









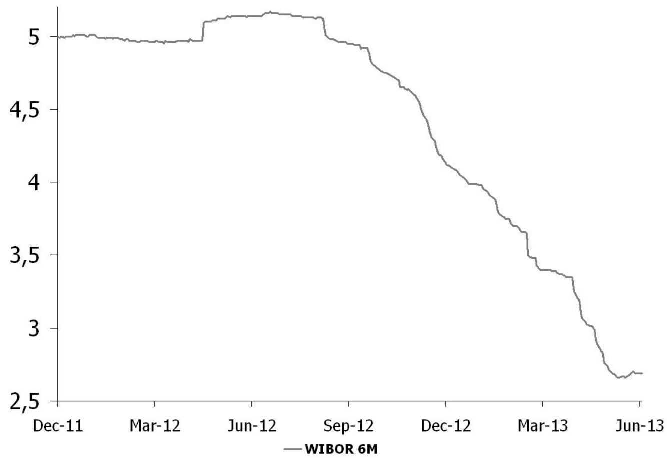
Money market

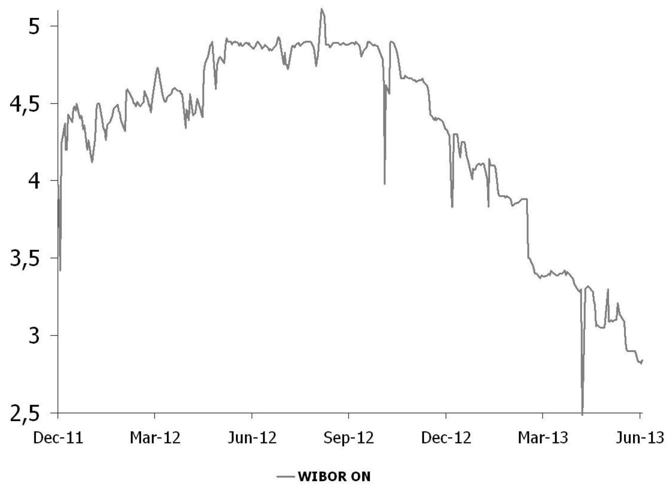
What about additional OMO? Today's OMO again well underbid (123 vs 133 bln pln on the offer). Last week we had a similar outcome and expectations of additional OMO. It did not happen, though. Today we have a feeling that the market counts on an additional OMO again. If it does not happen, we will face extremely an cheap end of the reserve.

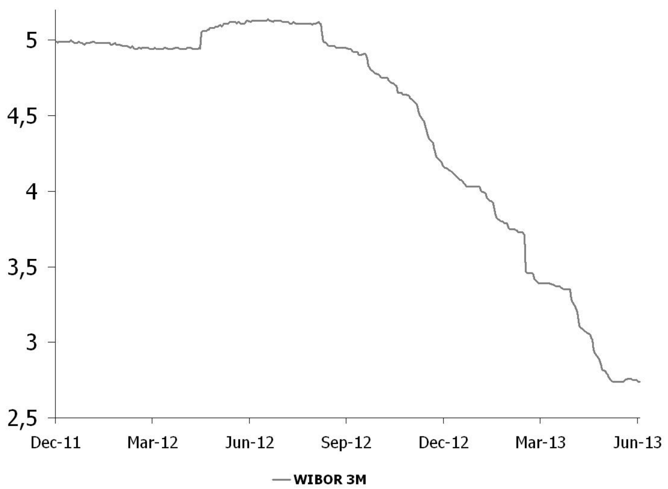
Moreover, it could also mean slow a drawback from Polonia stabilization target. As we were writing many times, this goal simply does not make any sense from the perspective of market liquidity and monetary policy channels. What it does make, is artificial shaping of the MM curve and a possibility for liquidity desks to earn extra money on a very well yielding and very safe and convenient asset.

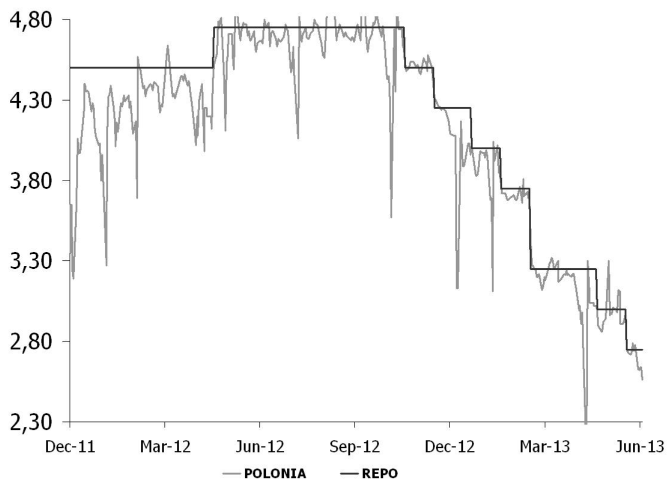
What is the trade-off? Interbank market liquidity (deposits, buy sell backs, ois) versus clean table effect (all the rates consistent). For us interventions draw liquidity from the interbank market giving little in return (it is convenient and profitable for liquidity managers but extra profits from the money bills could be paired off by extra profits on investment portfolios due to lower cost of carry, hence it lefts us mainly with convenience). We definitely opt for liquidity of the interbank market then for convenience.

FED again dominates expectations Fed again brought correction for PLN, and we again perceive it as a good opportunity to receive rates. Next week we have retail sales data (negative number) and a 50 bps cut, even if not highly probable, may still be in the agenda.





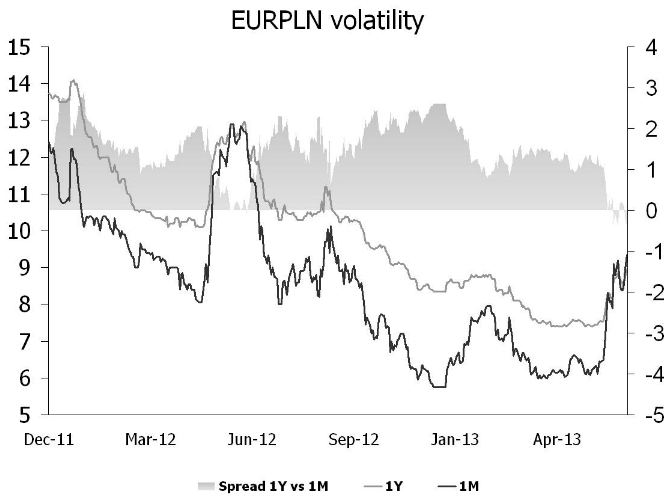




Forex

Volatility is back The FOMC knocked out all EM currencies. EUR/PLN spiked to 4.3490 (from 4.28) for a short time and is now traded around 4.32. The moves in emerging markets have already been severe, but there is big probability that more pain is to come... Albeit we have our CB - NBP's Raczko said that the NBP can do nothing about the trend although it may offer from time to time to bigger spikes. Generally even if interventions appear it may help zloty only in the short term.

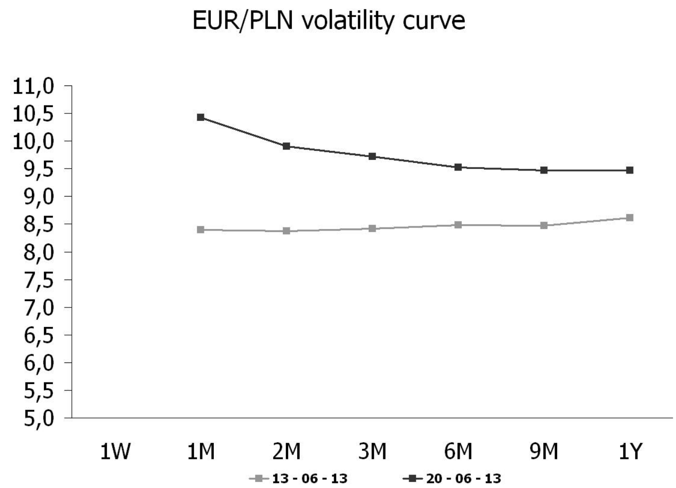
The vol of the vol It was a very exciting week on the options market. We can say that we observed some panic. The short squeeze buying moved up the front end by almost 5%!!! 1W atm has exploded from 9.0% to 14% (it's a 55% change). 1 month EURPLN jumped from 8.4% to 10.0% mid. 3 month EUR/PLN ATM mid moved from 8.4% to 9.8%. The EUR/PLN 1 year ATM has jumped from 8.7% to 9.8%. The skew also shot up aggressively - risk reversals jumped around 0.5% (now 25RR 3M is 2.4%, 25RR 1y is 3.0%). Currency spread (the difference between EUR/PLN and USD/PLN) is now around 5.0%.



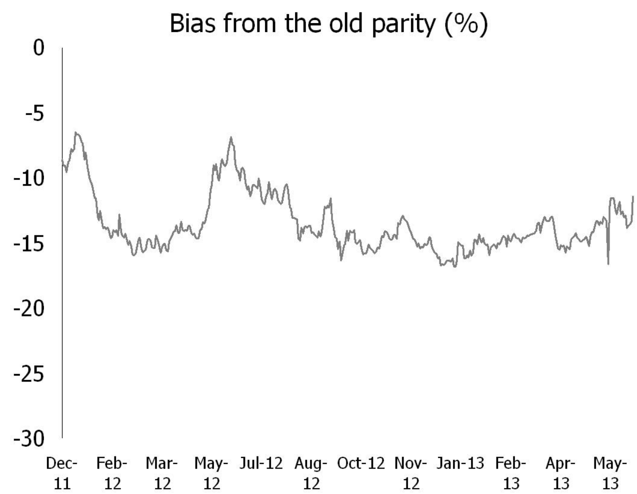
Short-term forecasts

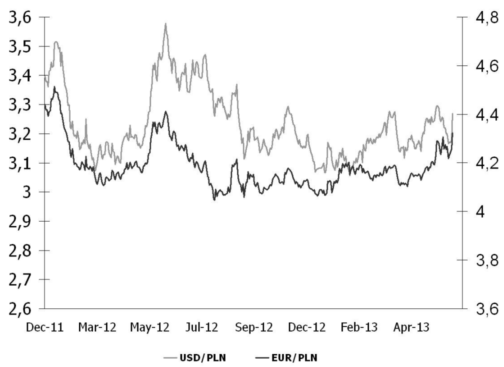
Main supports and resistances
EUR/PLN: 4.2800 / 4.3800
USD/PLN: 3.1500 / 3.4000

BUY EUR/PLN on dips. The bigger picture favours a range for EUR/PLN - 4.28/4.45. As a result, we are opportunistically skewed to the upside for a short term bet. Now we are long EUR/PLN at 4.3150 ready to add at 4.2900 with a stop below 4.2800 and hoping for the a revisit of 4.35/4.38 to take profit. Lets face it, the 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 the US, all the emerging world is an addict to QE. While it stops or even slows we will have risk off again.



Derivatives. We think volatility is back for good. We are already long Vega in EUR/PLN and looking forward to add on dips - our preferred tenors are in the backend. 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
6/14/2013	2.56	2.75	2.61	6.49	2.67	6.59	2.57	2.50	2.49	2.52	2.65	2.55
6/17/2013	2.52	2.75	2.52	2.59	2.61	2.58	2.59	2.53	2.56	2.58	2.69	2.61
6/18/2013	2.50	2.75	2.57	2.59	2.71	2.58	2.61	2.58	2.61	2.66	2.78	2.67
6/19/2013	2.51	2.74	2.58	2.59	2.70	2.58	2.61	2.55	2.57	2.64	2.79	2.67
6/20/2013	2.51	2.74	2.57	2.59	2.62	2.58	2.68	2.66	2.75	2.89	3.06	2.86

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
6/14/2013	6.590	3.353	3.292	3.275	3.420	3.351	3.630	3.873
6/17/2013	2.580	3.114	3.263	3.148	3.370	3.270	3.575	3.755
6/18/2013	2.580	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/19/2013	2.580	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/20/2013	2.580	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
6/14/2013	8.38	8.38	8.43	8.55	8.55	2.85	0.73
6/17/2013	8.55	8.45	8.50	8.65	8.65	2.85	0.73
6/18/2013	8.95	8.78	8.68	8.76	8.76	2.71	0.65
6/19/2013	9.35	8.90	8.90	8.95	8.95	2.82	0.73
6/20/2013	10.43	9.73	9.53	9.48	9.48	2.90	0.65

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/14/2013	4.2180	3.1654	3.4244	3.3327	1.4484	0.1644
6/17/2013	4.2316	3.1719	3.4368	3.3450	1.4542	0.1644
6/18/2013	4.2406	3.1682	3.4453	3.3292	1.4559	0.1654
6/19/2013	4.2563	3.1777	3.4535	3.3459	1.4472	0.1659
6/20/2013	4.3237	3.2693	3.5079	3.3421	1.4464	0.1682

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