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Comment on the upcoming data and forecasts

PMI (Monday) should not rebound significantly: the external environment is still unfavorable (German PMI declined in June, Ifo rose only slightly), CSO's own sentiment indices decreased and the structure of PMI in the previous months remained unconvincing. The road to recovery seems painfully long. All eyes will be focused on the MPC, though. We expect the Council to cut rates again by 25 bps and thus conclude the cycle, although the statement might not be as unambiguous as many market participants expect. The cut will be influenced be the new NBP staff projections. As we argued in one of our previous weekly reviews, the new inflation path will be markedly higher than the previous one but not steep enough to reach NBP's inflation target. The final cut should adress that.

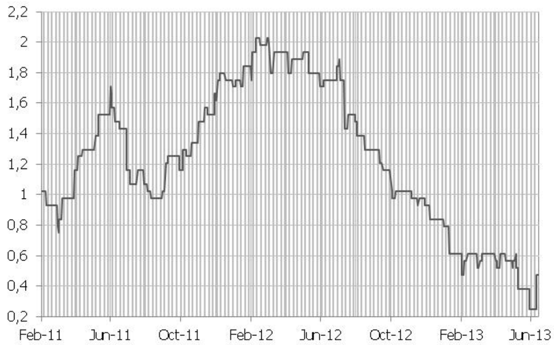
Polish data to watch: July 1st to July 5th

Publication	Date	Period	BRE	Consensus	Prior
Manufacturing PMI (pts)	01.07	Jun	48.3	48.2	48.0
NBP rate announcement (%)	03.07	Jul	2.50	2.50	2.75

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

A big surprise on Tuesday - unemployment rate came out 0.2 percentage points below market consensus, hence a large increase in the surprise index. Not much room for surprises next week (PMI is the only release), as expectations remain very conservative here. We reiterate our short term view on the index: consolidation around current levels.

* Surprise index presents in a synthetic way how the market was surprised by

Our view in a nutshell

Fundamentals

- Available data confirm stagnation in H1 2013.
- We expect economic revovery in H2 2013. The rebound will be driven by a re-acceleration of the euro zone economy (see the end of austerity), rebound in real income and recovering private consumption. Low rates trigger rotation in households assets. However, given the scale of slack in investment (infrastructure in particular) and consumption, rebound generated this way may be initially moderate (no more than 2% y/y growth rate in Q4 2013).
- 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

- 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).
- In a short term we are again constructive on Polish long end bonds.
- 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

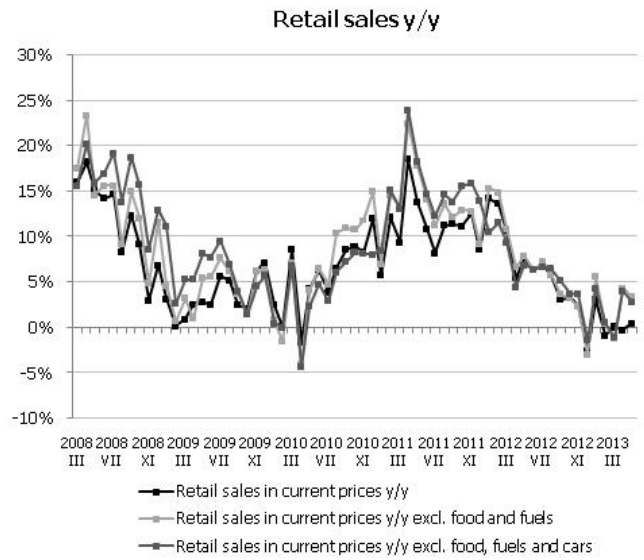
	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.5	2.3	1.3	0.7	0.5	0.6	1.2	1.7
Individual consumption y/y (%)	1.7	1.3	0.2	-0.2	0.0	0.5	1.3	1.9
Public Consumption y/y (%)	-1.0	0.4	1.6	-0.6	-0.5	0.5	0.5	0.5
Investment y/y (%)	6.8	1.4	-1.7	-4.1	-2.0	-4.5	-3.0	-2.5
Inflation 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	4.00	4.20
EUR/PLN (eop)	4.15	4.22	4.12	4.08	4.18	4.30	4.20	4.15
USD/PLN (eop)	3.11	3.35	3.20	3.09	3.26	3.31	3.36	3.40

F - forecast

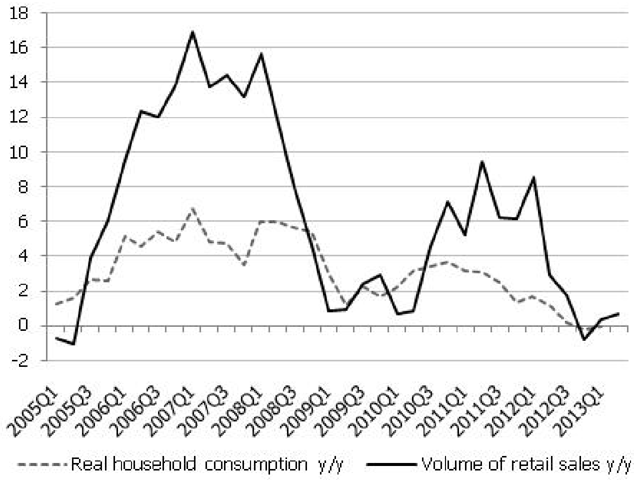
Economics

Retail sales growth is another symptom of a rebound in H2

Retail sales grew by 0.5% y/y (consensus: +0.3%, our forecast: -1,2%). We have already noted in the previous month that incoming data will be closely monitored for signs of trend reversal (especially in durables). Another minus in our forecast was due to statistical effects (Easter-related shifts, working days, extended weekends). We dare to say that this is a solid release (to the extent that our interpretation of base and calendar effects is correct, they were likely beaten by a steepening trend) and retails sales has probably bottomed out. It is confirmed by core retail sales aggregates.



Our expectations of a rebound in food sales have materialized (+4.8 y/y vs. -3.6% in the previous month). Moreover, sales of cars continued to post a sizeable increase (+6.0%). Other core categories grew roughly as much as in the previous month (between 8 and 10% y/y): a subtle uptrend is clearly visible in these categories. It is not surprising, if we take into consideration the following factors: low interest rates, shifts of savings into overnight deposits and a continued improvement in real disposable income. Consumption is supported by an upward shift in current (price effects) and permanent income (labor market is bottoming out) as well as intertemporal substitution of consumption (due to low interest rates). Household spending has reached a bottom and the second half of the year is likely to be better (see graph below).



The data had no effect on the market. We believe that poor retail sales growth will be considered as an argument for another rate cut in July. Despite encouraging details, the Council should focus on the headline. The same story applies to industrial output data - a negative is still a negative even if above what we could expect from high statistical base and calendar effects. Moreover, retail prices (incl. core categories) are falling which confirms strong disinflation underway.

Reforming the private pension system - most likely scenarios and impact on financial markets

The governmental review of pension system presented on Wednesday includes (apart from the widely anticipated proposal for pension payments) recommendations for changes in the structure of the system, i.e. a complete overhaul of the private "pillar". As far as payment options are concerned, the government proposes that funds accumulated in private funds will be transferred to a sub-account within the state pension fund (ZUS) 10 years before retirement and subjected to the same indexing rules as assets in the public system. As for the overhaul, three options have been put forward:

1. All assets except equities to be transferred to ZUS - T-bonds held by pension funds would thus be redeemed. At the same time, private funds would be prohibited from investing in the bond market but their limits and benchmarks for other asset types would be modified accordingly.
2. Participation in the private part of the system would be strictly voluntary and one's failure to declare it would result in an automatic transfer of all personal assets to ZUS (bonds redeemed, equities sold).
3. The third option is very similar to the second one but here one's participation in private funds would be associated with a higher contribution.

Details for all three proposals are provided in the report (pages 86-91, in Polish). Our goal is to briefly present their likely impact on the financial markets and assign probabilities.

Firstly, all proposals are, on balance, more negative for bonds than for equities. This is partly because the stock market has already priced in the most negative scenario (private pension funds completely disbanded). The FI market, on the other hand, has largely ignored the issue until now.

The first proposal is a major blow to market liquidity (pension funds hold ca. 120 bln PLN worth of government bonds) and a drastic shift of public debt ownership structure towards non-residents. This would increase Polish bonds' susceptibility to changes in global sentiment. In this situation both the MF and the NBP would have to become more active in managing debt and FX markets (see the case of Romania where the non-residents' share tripled in the last four years). This would also lead to the steepening of the yield curve, as pension funds typically prefer longer durations. Debt-to-GDP ratio would be reduced immediately (automatic redemption of all bonds held by pension funds), which itself is positive for Poland's ratings. This scenario is also a boost for the stock market and for corporate bonds (pension funds would not be forced to reduce their involvement in these asset classes).

In case of second and third proposal it is crucial to pin down the exact number of citizens who decide to leave the private pension funds. We think the outflow may be substantial as the proposal assumes ZUS membership as a default state which can of course be changed but it demands some effort from the citizens' side. These proposals are equity- and debt-negative. From the government's point of view their flaws include the unknown scale of asset outflow to ZUS and hence also the unknown scale of public debt reduction. Moreover, management and consecutive sale of equities by ZUS seem also a comprehensive and delicate matter. Even under management of ZUS equities (if not sold) are not going to lower public debt; only bond redemption and cash can do the trick.

It seems public opinion expects proposal two or three to take the upper hand. Such a view was strengthened by PM Tusk who spoke (albeit enigmatically but still) for the voluntary nature of pension system. However, we think this option may cost dear in terms of many technical problems and a critique voiced not only by pension funds but also by many experts which are going to mushroom exponentially only to take part in the lively debate. It could be detrimental for political support, hence ex ante not so likely to be really chosen by the government (we think the government is fully aware of the consequences). Therefore, we would rather think that the first proposal has the greatest chance to be picked. It has several merits: already known scale of debt reduction (11% of GDP), minimal risk of a prolonged and PR negative debate. Moreover, it leaves intact the core activity of private pension funds, i.e. investing in the real economy (equities, corporate debt) and not only rolling the public debt.

The choice of the final option may take no less than 3 months and the bill is unlikely to be finished before the year end (the changes to pension system will be effective in H2 2014). It is possible that - as many investors already believe - pension funds may already start to rotate assets towards instruments different from state bonds in order to protect a greater part of their assets from being transferred to ZUS (up to the 47% allocation limit). Expectations of such an action or the action itself may lead to a rise in yields and provide support for the equity market. **We remind though that this factor is likely still play only a background role to changes in yields driven by global factors (currently positive for Polish bonds)**.

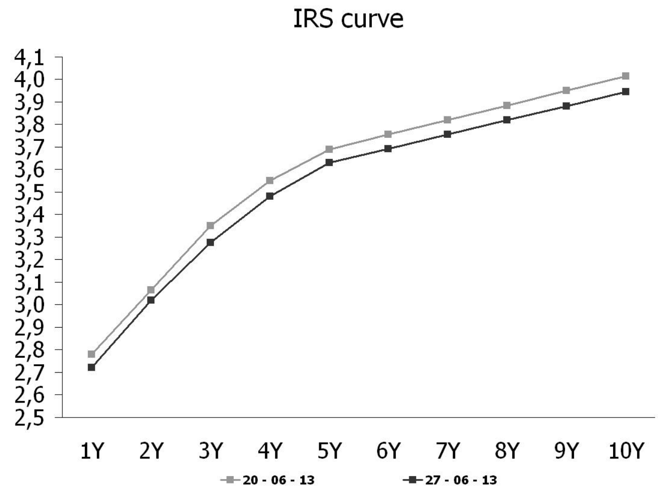
Fixed income

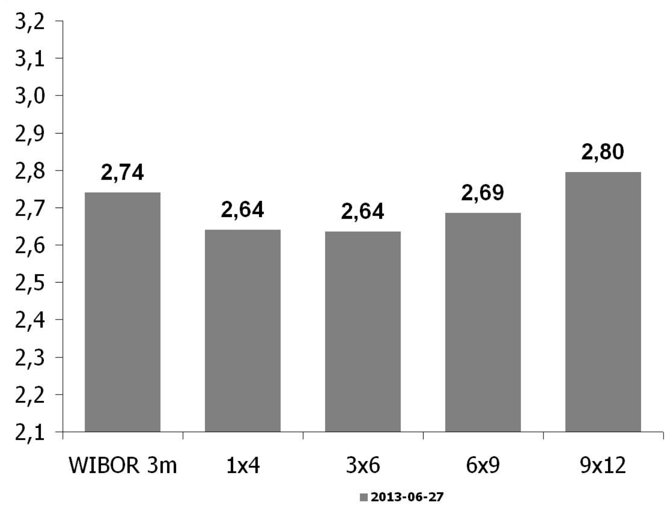
Correction in uptrend

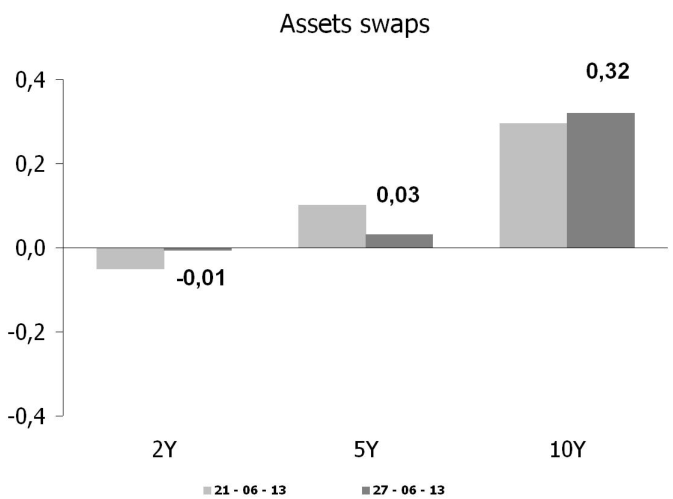
It is needless to say that global rates' trend has changed. Higher core yields eager bears for a strong sell-off. As a result we have printed new highs on POLGB yields:
2y - 3.25% high, 3.00 week close, 2.47 May low
5y - 4.00% high, 3.58 week close, 2.61 May low
10y - 4.55% high, 4.23 week close, 3.05 May low

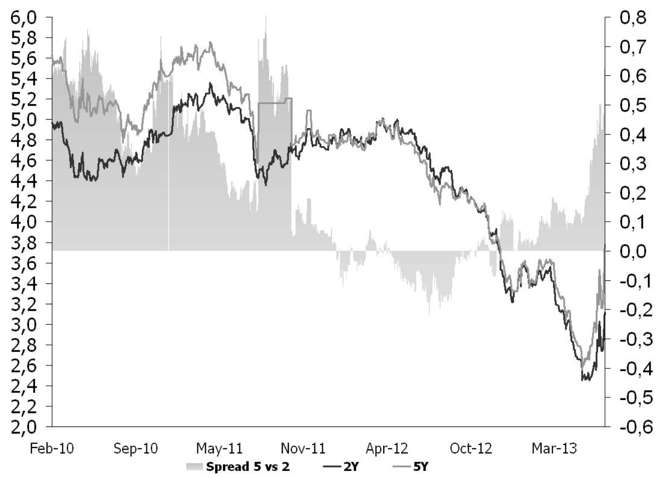
Is selling a proper direction? We think so. Is this a good level? Not necessary. Mid- and longend emerging markets bonds trade now with about 80% correlation with core markets. While global bonds sell-off stopped (for now), we should see some correction/consolidation now. With such volatility (Realized volatility on 10Y POLBGs is about 20% now!) we should easily get back to 4.00 level.

What is our view for the correction then? Buy 1Y-3Y bonds. Current levels (2.90-3.20%), compared to the price of cash (about 2.55% if 25pts rate cut happens) creates decent carry space which should be quickly occupied by bank books.





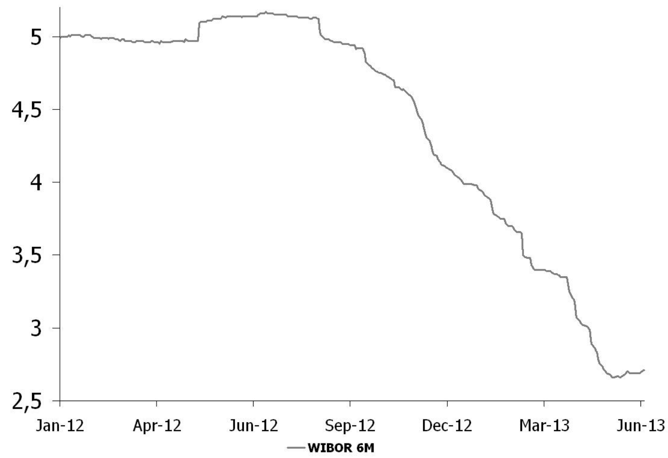


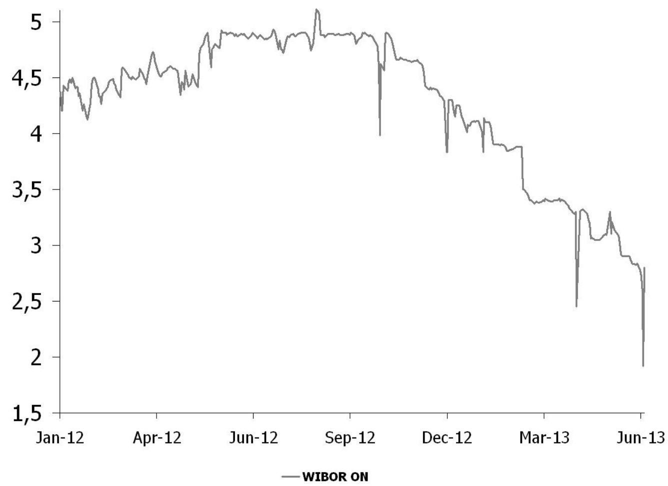


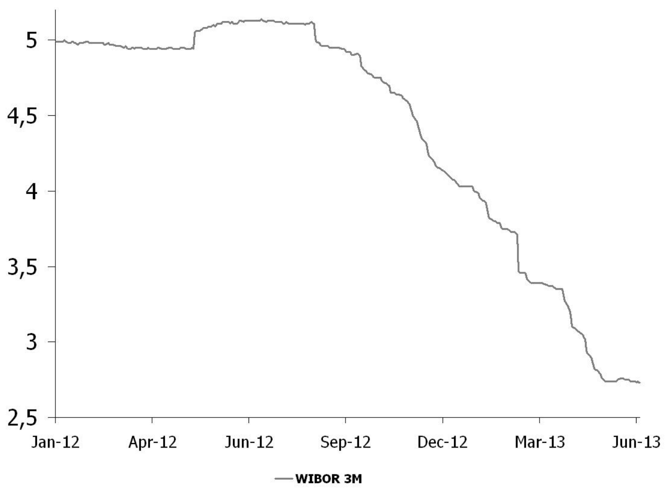
Money market

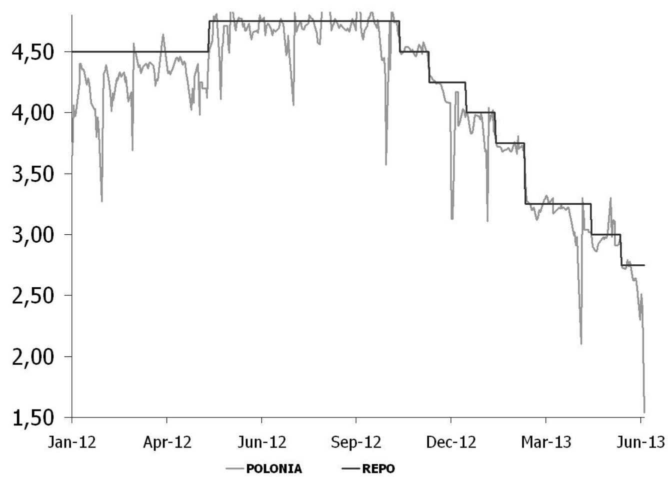
Cheap end of quarter Second quarter ends flooded with cash from liquidity desks, and even an additional OMO on Monday didn't manage to sterilize the market. This makes bond holders and OIS sellers happier. The one and three month average spread between the reference rate and Polonia widened from 3 to 17bp and 10 to 15 bp respectively. Perhaps that's just a one-off due to quarter end but big enough for us to widen assumed spread for OIS pricing from 8 to 10 bp on average.

Main theme of the ending week was the selloff in global bonds which of course affected the local market. At some point it looked like a panic with 1 year bonds being droped at 2,90% ytm. With a rate cut on the way and cheap cash we would try to buy these to get 40 bp carry, or just to sell them on the swiching auction.





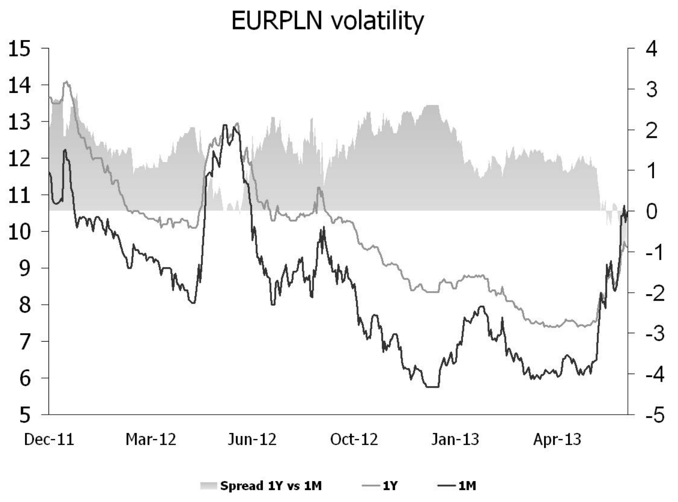




Forex

Higher in range At the beginning of this week Zloty opened with strong bid tone, as the poor US data was released. On Tuesday EURPLN plunged even to 4.2915 but it recaptured quickly and finally closed at 4.3340. Headlines around a proposed Polish government recommendations to ban pension funds from investing in government bonds only fuelled the PLN weakness further. Anyway, the global sentiment is a core driver of PLN, and we doubt that any local news may stand in the way...

The vol of the vol The volatility of the volatility is still in style - especially in the frontend of the curve. At the beginning of the week EURPLN 1 month ATM was even bid on at 10.85% and now is traded at 9.75%. 1w atm has dropped to 11.0% from 14% last week. The backend of the curve was stable - the 1 year is now 9.7% mid. The skew is unchanged.

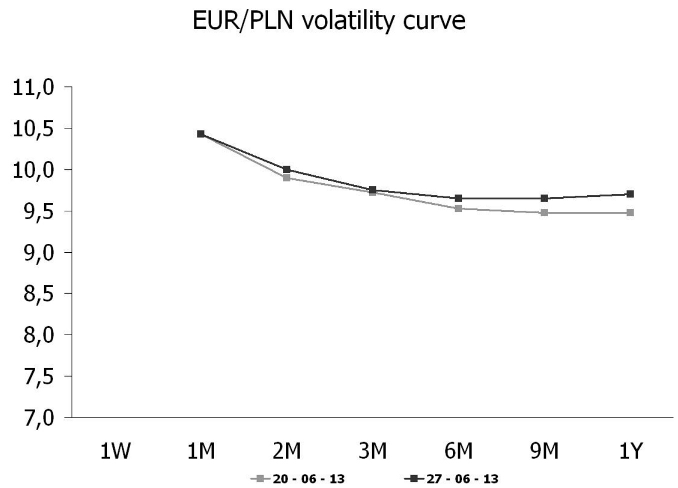


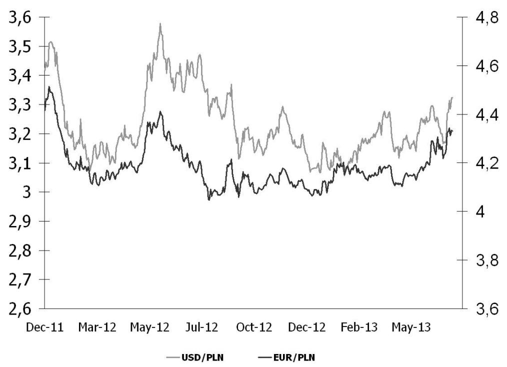
Short-term forecasts

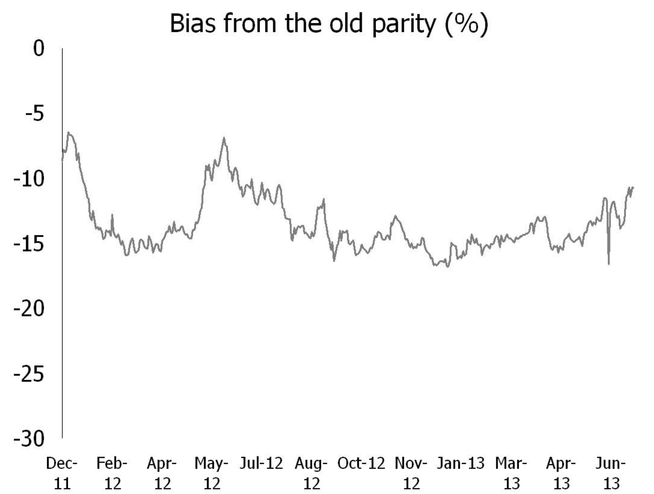
Main supports and resistances
EUR/PLN: 4.2800 / 4.3800
USD/PLN: 3.1500 / 3.4000

BUY EUR/PLN on dips. EURPLN remains within 4.30 - 4.35 range, without impetus for a move either way, and only a break through these levels will open up a bigger move. However, we are skewed to the upside. Now we would buy again at 4.3100, ready to add at 4.2900 with a stop below 4.2800 and hoping for the revisit of 4.35/4.38 for profit taking.

Derivatives. We think volatility is back for good. Being Long Vega and Gamma, you at least know what is your possible loss (Theta, even if it may be very high). Being short Vega, Gamma, Vanna or Volga is a big unknown. Overall, we are better bids for above. 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.







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
6/21/2013	2.55	2.74	2.66	6.49	2.79	6.59	2.67	2.66	2.75	2.91	3.22	2.87
6/24/2013	2.49	2.74	2.46	2.59	2.63	2.59	2.69	2.68	2.79	2.97	3.22	2.97
6/25/2013	2.47	2.73	2.62	2.60	2.78	2.59	2.67	2.66	2.75	2.90	3.18	2.86
6/26/2013	2.44	2.74	2.55	2.60	2.74	2.60	2.66	2.64	2.72	2.83	3.11	2.81
6/27/2013	2.42	2.73	2.55	2.61	2.72	2.61	2.64	2.64	2.69	2.80	2.99	2.78

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
6/21/2013	6.590	3.353	3.292	3.275	3.420	3.351	3.630	3.873
6/24/2013	2.590	3.114	3.263	3.148	3.370	3.270	3.575	3.755
6/25/2013	2.590	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/26/2013	2.600	2.992	3.218	3.137	3.325	3.237	3.525	3.759
6/27/2013	2.610	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
6/21/2013	10.43	9.78	9.58	9.46	9.46	3.02	0.73
6/24/2013	10.70	10.10	9.75	9.73	9.73	3.02	0.73
6/25/2013	10.25	9.85	9.60	9.60	9.60	2.93	0.74
6/26/2013	10.53	9.85	9.60	9.58	9.58	2.92	0.66
6/27/2013	10.43	9.75	9.65	9.70	9.70	2.94	0.74

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/21/2013	4.3284	3.2743	3.5289	3.3494	1.4487	0.1675
6/24/2013	4.3432	3.3137	3.5465	3.3785	1.4463	0.1677
6/25/2013	4.3118	3.2840	3.5174	3.3830	1.4542	0.1672
6/26/2013	4.3348	3.3239	3.5364	3.4051	1.4577	0.1678
6/27/2013	4.3314	3.3241	3.5207	3.3869	1.4653	0.1673

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