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Comment on the upcoming data and forecasts

On Tuesday the Central Statistical Office will publish the latest Statistical Bulletin along with retail sales and unemployment data. As for the former, we expect y/y growth to accelerate further mainly on working day effects. The headline should, as it happened in the previous two months, hide very encoraging details regarding sales of durable consumer goods. Unemployment rate has declined even further - our initial forecast was confirmed by early estimates from the Ministry of Labor and Social Policy.

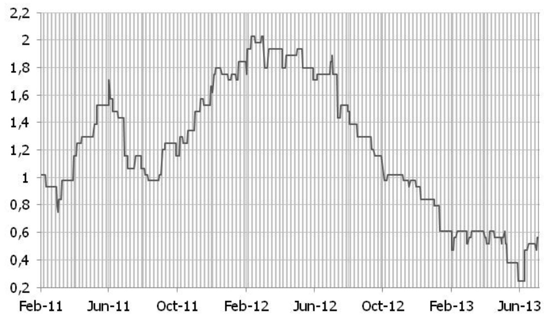
Polish data to watch: July 22th to July 26th

Publication	Date	Period	BRE	Consensus	Prior
Retail sales y/y (%)	23.07	Jun	1.7	1.0	0.5
Unemployment rate (%)	23.07	Jun	13.2	13.2	13.5

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

Down on low inflation (food prices have not accelerated as we had feared) but up on industrial output and prices data. Overall, the index rose on a weekly basis and remains on track to overcome its renewed weakness. Since surprises often come together, a positive surprise in retail sales data is not completely out of the question. We expect further increases along the way as the economy gradually recovers in the second half of the year.

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.
- However, we expect economic recovery 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. 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), albeit higher than current market consensus dominated by rather gloomy visions.
- Polish government committed to the convergence path, though in a very unorthodox and elastic way. As the European Commission gave the government two additional years to bring down GG deficit towards 3%, budget amendement is coming at PLN +16 bn to deficit. This - along with the political business cycle - opens room for fiscal stimulation. Formal acceptance of the EC (and overal trend of consolidation's fatigue) suggests the market should digest this information easily.
- We witnessed the steepest disinflation phase in Polish history. CPI inflation close to 0% in mid 2013 but is to rise slowly in Autumn and in 2014.
- Despite low inflation, there is no support for further easing within the MPC, the more so since the momentum in the real economy improved. July rate cut marked the end of the easing cycle. We expect first rate hikes to materialize at the turn of 2014/2015 and think that NBP projections of both GDP and inflation for 2014 are be too pessimistic.

Financial markets

- We stay contructive on short-term bonds (ECB supports low rates in Europe introducing Fed-style forward guidance, NBP follows although in a less straigtforward way and at the moment only via governor's rhetoric, not the statement of the whole body). Note that NBP may also use unconventional 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. We expect a return below 4.20 when the economy accelerates visibly (long into H2) or/and rate hike expectations gain momentum (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	-1.9
Unemployment rate (end of period %)	9.5	12.1	12.4	12.5	13.4	13.7
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	0.5	1.2	1.7
Individual consumption y/y (%)	1.7	1.3	0.2	-0.2	0.0	0.4	1.3	1.9
Public Consumption y/y (%)	-1.0	0.4	1.6	-0.6	-0.5	0.3	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	0.3	0.9
Unemployment rate (% eop)	13.3	12.4	12.4	13.4	14.3	13.4	13.3	13.7
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	2.85	2.85	2.90
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.74	3.94	4.20	4.00	4.40
EUR/PLN (eop)	4.15	4.22	4.12	4.08	4.18	4.30	4.20	4.10
USD/PLN (eop)	3.11	3.35	3.20	3.09	3.26	3.31	3.36	3.36

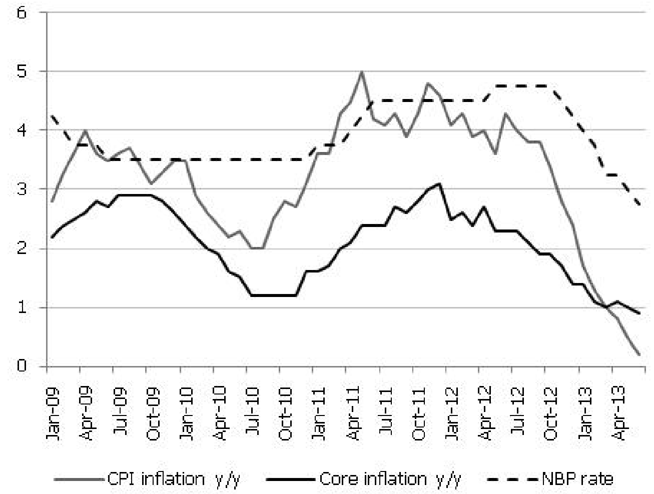
F - forecast

Economics

Cornerstone for growth is here. Forget about rate cuts. Potential for momentum-based hike expectations is high.

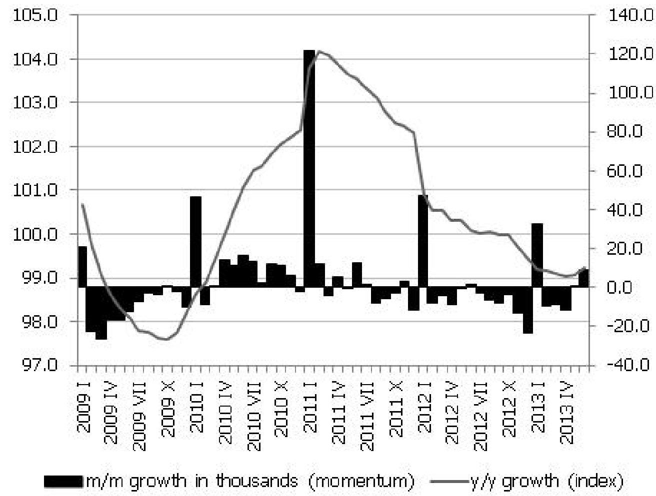
Recent data filled us with cautious optimism on the Polish economy. Real sphere data are on the mend. We link it to consumer behavior (low interest rates and incentives to spend), somewhat looser attitude of the government towards expenditures, and some symptoms of a turnaround in the euro zone economy. We think that upswing is coming and that the market consensus - as usual - has a tendency to err on the side of caution near the trough. With the real sphere improving and base effects on inflation ebbing we see a steeper CPI growth path. The momentum of data is likely to support rate hike expectations for 2014.

CPI inflation declined from 0.5% to 0.2% in June. This is the lowest y/y dynamics ever recorded in Poland, dangerously close to the psychological barrier of zero. Delving into details, inflation has fallen again due to relatively low food prices (increases in the prices of potatoes turned out to be lower than Czech data suggested) and stable prices in other categories. As far as core categories are concerned, most of them were unchanged (telecommunications, health services) or slightly lower (educational services, clothing and footwear) compared with the previous month. Fuel prices rose by 0.8%, slight increases were also recorded for recreational and cultural services, as well as hotels and restaurants. Core inflation ticked down from 1.0% y/y to 0.9% y/y.



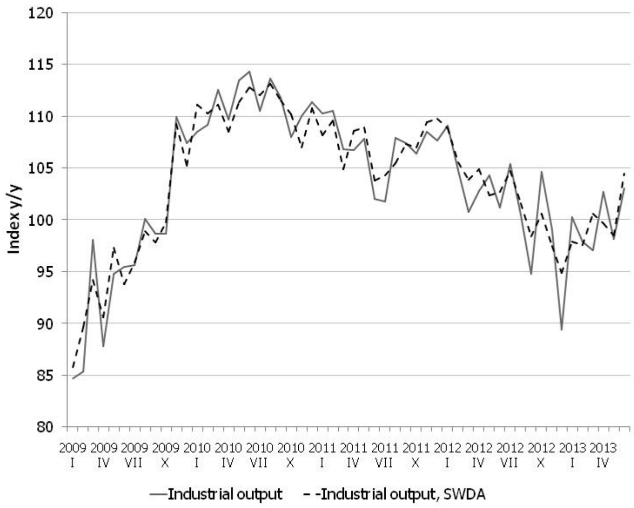
In July CPI growth should increase to 0.5%. Higher fees for waste disposal (up to 100%) will be accommodated by lower electricity prices and lower payments for mobile roaming services. Inflation is set to remain low until year end (below 1% in the coming months). Core inflation should stay at a higher (current) level but also stable around 1%. That being said, inflation should reaccelerate in 2014. We estimate low statistical base to amount to over one percentage point. This, along with a rebound in the real sphere, should lead to inflation faster than 2% y/y at the end of 2014.

Employment in the enterprise sector rose by 9k on a monthly basis. Therefore, annual growth of employment improved to -0.8% from -0.9%. We sustain our view that the trough in the labor market has been reached and it is possible that annual dynamics of employment will rear its head above zero until the end of the year. Such a view is corroborated by the momentum in disaggregated data and business tendency indicators as well.



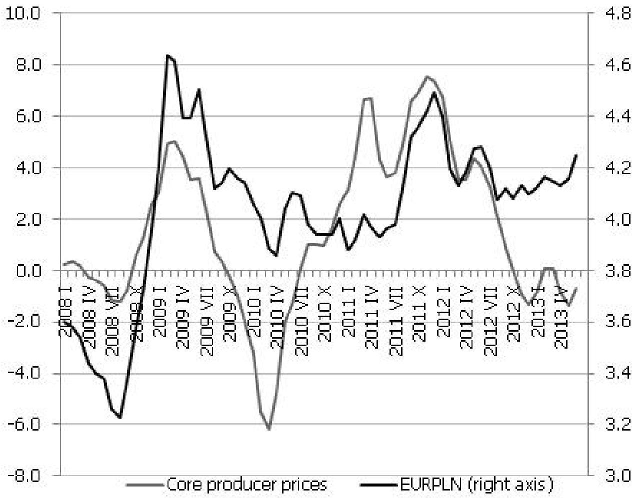
Wages grew by 1.4% y/y, significantly below market consensus (2.3%) and our own forecast (2.9%). As usual - because only the headline was released - it is impossible to comment on the causes of this surprise. However, since deviations from trend have recently been due to one-off factors such as shifts of bonuses in certain sectors, it is reasonable to assume that similar factors weighed down on wage dynamics this time as well. Such a view is also corroborated by very decent growth in industrial output (see the comment in subsequent paragraphs), well correlated with the core component of wages.

Industrial output in June by 3.0% y/y beating market consensus (consensus 1.3%, our forecast 2.1%). Even more handsome is the growth in seasonally adjusted terms at +4.5% y/y.



Growth in output owes much to last year's statistical base, although momentum (as we just found 2 months ago) also systematically improves. Moreover, the composition of output growth suggests the positive headline is something more than a pure luck as export sections lead the way. Speaking from experience, upswing in exports usually spills over onto other sections which are additionally poised for better results as domestic demand improves (with consumption improving first). Short-term perspectives are also optimistic. Next month is likely to bring output growth at 5-6% y/y. In terms of broader macroeconomic aggregates, fresh industrial output reading suggests that Q2 GDP growth was not worse than in Q1.

Producer prices recorded an upside surprise (-1.5% y/y versus market consensus and our forecast at -1.8%) and it is not because of higher prices in oil-related industries. We recently stipulated that producers seriously walked away from exchange rate in their pricing behavior (see the graph). We argued this was because of the loss of pricing power on very shallow market (recession in domestic demand). We are now more inclined to think that this process may be coming to an end. Therefore, we look for something like convergence between producer prices and EURPLN rate in the coming months as macroeconomic conditions are improving.



Construction output dropped by 18.3% (above market consensus at -21% and slightly above our forecast at -19.3%). As we've been repeating for some time, poor annual construction figures are legacy of the past (statistical base). However, monthly growth is improving and therefore also the momentum. The return of public investment is crucial for the outlook for the nearest months. Tenders for expressways financed from the new EU financial framework suggest 2014 will be much better for construction sector.

Budget amendment. On Tuesday, PM Tusk announced that the government will be forced to amend the budget this year. Due to dire economic conditions in the first half of the year the shortfall in tax revenues (VAT and CIT in particular) has already exceeded 15 bn PLN and it is not inconceivable that this gap continues to widen even when the economy starts to rebound. Furthermore, expenditures are kept in line only because the Ministry has replaced the usual subsidy for the state pension fund (FUS) with an off-balance loan (a temporary solution). The budget will be amended by 24 bn PLN and the amendment is a mix of a larger deficit (by 16 bn) and expenditure cuts (8-9 bn). The latter have not been specified but are supposed not to hurt economic growth. Increased deficit will be financed partly by new bond issuance and loans from international institutions. As a result, Poland will miss its fiscal target for this year - we expect the general government deficit to increase to ca. 4.5% of GDP.

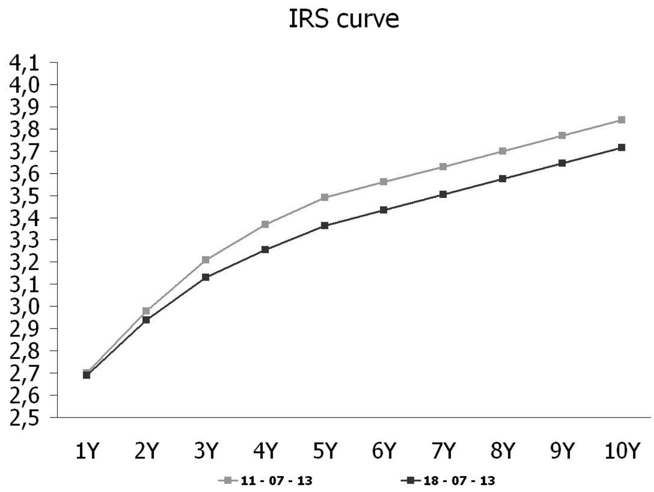
MPC outlook. Apart from inflation data, anything published last week fits nicely into growing expectations for monetary policy tightening in 2014. We also think it is the final thrust to the remnants of further monetary easing that until recently can be still read in some reports. Subsequent data releases (slowly accelerating inflation and glacially improving real sphere) will be generating expectations for rate hikes. However, actual rate hike may be more distant than the current market pricing. Remember that the Polish economy is slowly recovering from very low growth, core inflation is going to stay relatively low. In such circumstances the MPC may find comfort in staying idle for longer rather than tightening prematurely. Let's be honest: it is now a relatively common view that the MPC could have done better by cutting earlier; why then make the snowball running by pursuing earlier hikes? We think the MPC is going to begin raising rates in late 2014. However, this is not going to prevent market expectations (momentum view) from rising.

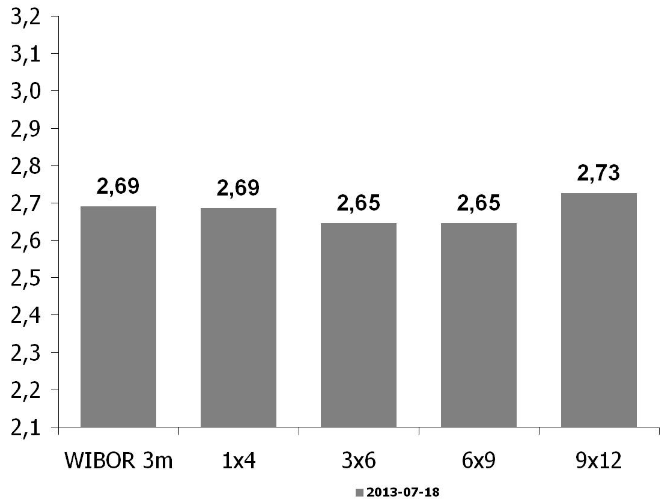
Fixed income

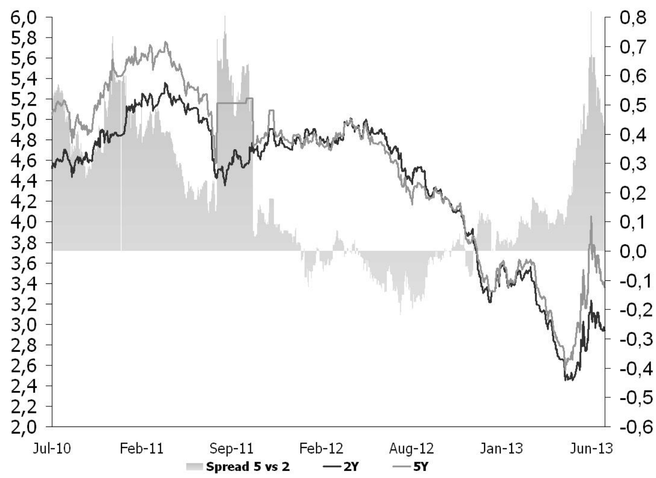
Mixed data

This week we saw very low CPI data (only 0.2% yoy) and surprisingly good industrial output (3% yoy). Market, however, was more concerned about global sentiment and we saw decent inflows on POLGBs in the second part of the week. The yield of DS1023 went up to 4.08 and came down to 3.92 at the moment. We still think that summer time is good for carry trades. With better global sentiment for EM bonds currently, our last week's 'buy DS1016 on dips' trade remains intact. Also, the Ministry of Finance just cancelled the auction planned for next week.

Good Luck.

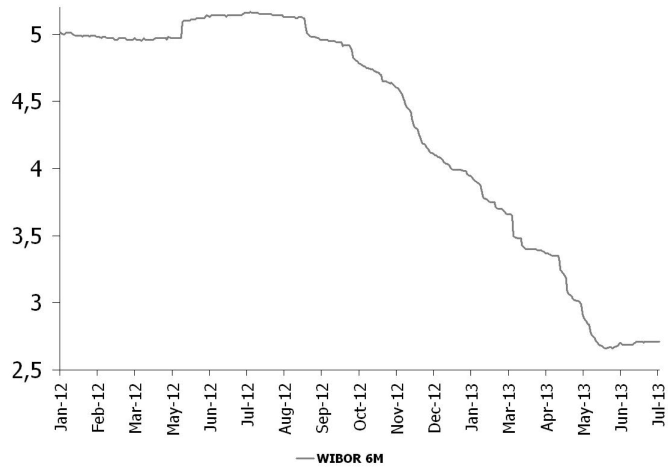


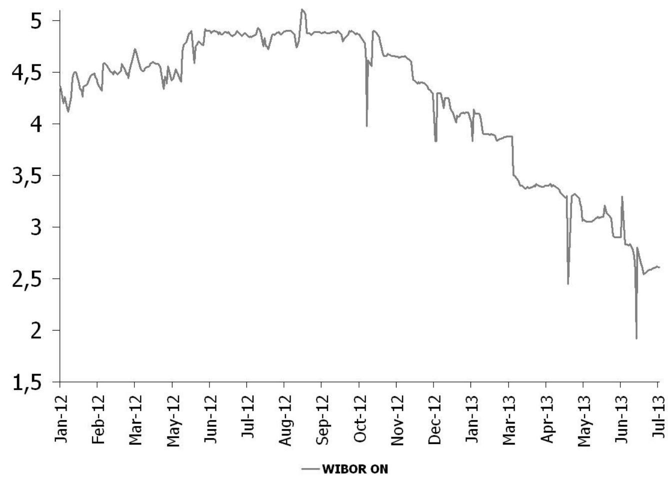


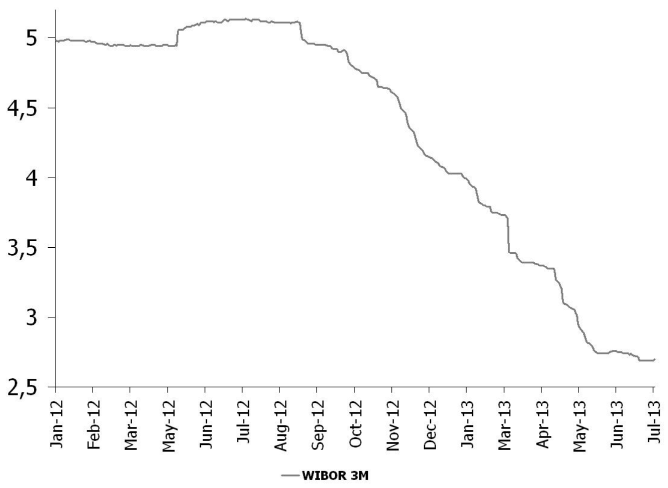


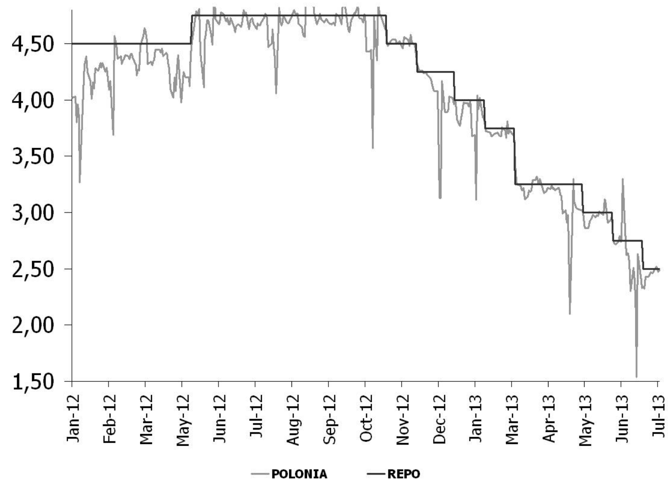
Money market

A quiet week Market volatility came down a lot last week - on the front end we move in a really tight range, not actually exceeding a 5bp spread. Polonia curve stays flat at 2,40% till 9 months and about 3 pips higher then. Incoming data was unable to shake the market as CPI went on the downside and production surprised on the upside so all in all neutral. Next week can be volatile in ON rates due to coupon and bond payments. Liquidity desks took a safe stance and bought only 123 bio NBP bills from 127 offered so we can see a lower cost of carry next week.









Forex

PLN stronger The risk is on again. PLN is much stronger and EUR/PLN has dropped to 4.2330 as a result (stop losses of PLN shorts were a vital ingredient for the move). Bernanke is dovish and Polish budget problems have been widely ignored. One has to respect the price action, so even though, the end of QE was also heralded, the risk rally is on. We are in the skeptic camp and think we are more in 4.22/4.25-4.35/4.37 EUR/PLN range. The US macroeconomic figures will guide us from now on.

Volatility dropped hard Stronger PLN forced the sell-off in EUR/PLN vols. 1 month EUR/PLN ATM fixed this week at 8.5% (versus 7.8% last week), 3 months are 8.3% (0.6 pp. down), 1 year 9.5% (0.5 pp. lower). It's quite a move, especially for the back end. The skew was also better offered with 6 months 25 D R/R given at 1.9%. The currency spread (difference between USD/PLN vol and EUR/PLN vol) moved lower us well, especially in the front end.

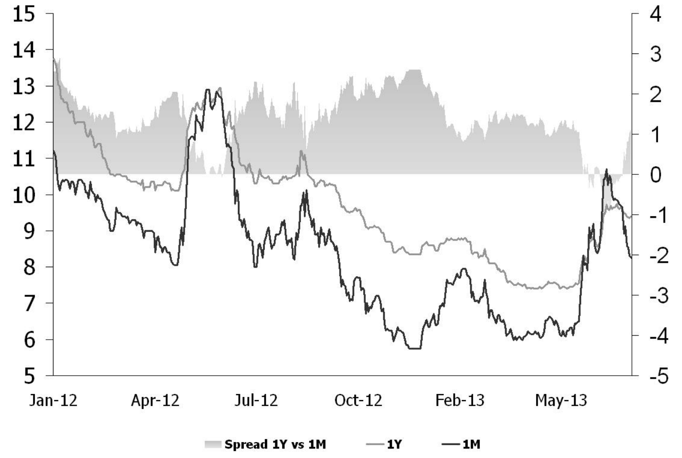
Short-term forecasts

Main supports and resistances
EUR/PLN: 4.2200 / 4.3700
USD/PLN: 3.1500 / 3.4000

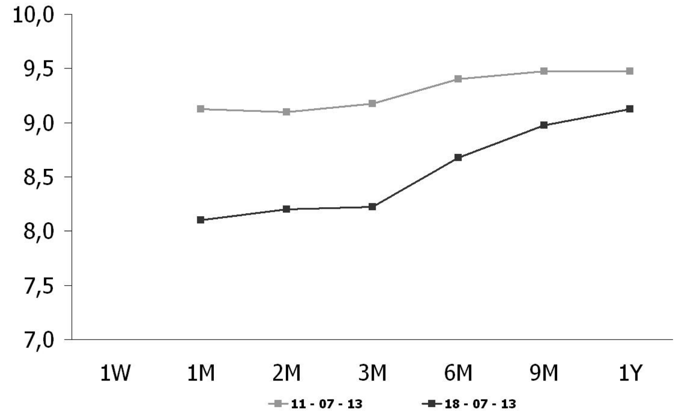
Buy EUR/PLN We think we are now in a 4.22/4.25-4.35/4.37 range. Now we are long 4.2500, ready to add 4.3000 with a stop below 4.2150 and hopes for 4.325+. It's purely tactical...

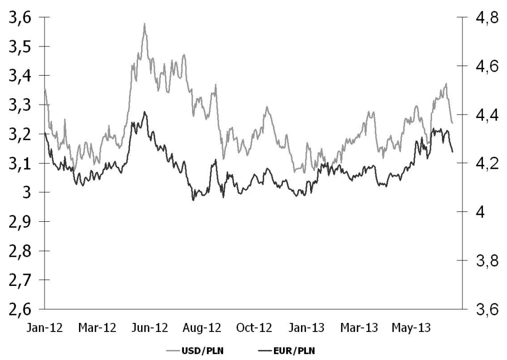
Derivatives. Volatility has corrected strongly and we are in full summer mode with liquidity being thin at best. In our opinion, by the book the adjustment period with US QE being reduced/ended should produce higher volatility in due time. For the time being the market proves us wrong, so we have to follow the US numbers to learn more.

EURPLN volatility

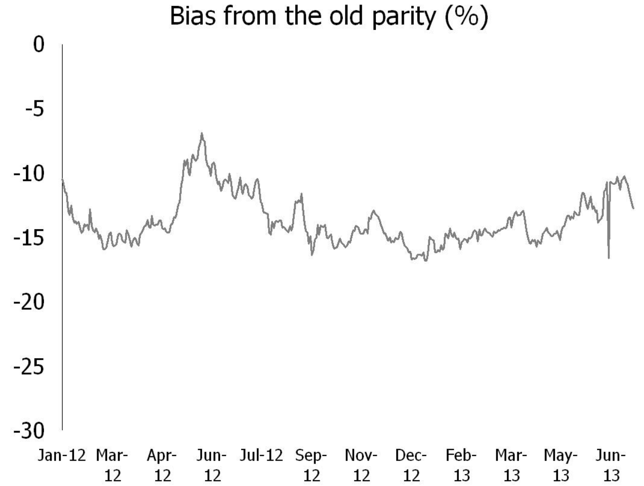


EUR/PLN volatility curve





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
7/12/2013	2.45	2.69	2.61	2.61	2.82	2.63	2.69	2.65	2.67	2.77	2.91	2.75
7/15/2013	2.46	2.69	2.57	2.61	2.76	2.63	2.65	2.66	2.66	2.73	2.87	2.74
7/16/2013	2.47	2.69	2.61	2.61	2.82	2.63	2.64	2.64	2.65	2.73	2.85	2.73
7/17/2013	2.45	2.69	2.56	2.61	2.78	2.63	2.65	2.66	2.68	2.78	2.93	2.76
7/18/2013	2.44	2.70	2.55	2.61	2.77	2.63	2.69	2.65	2.65	2.73	2.89	2.72

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
7/12/2013	2.630	3.353	3.292	3.275	3.420	3.351	3.630	3.873
7/15/2013	2.630	3.114	3.263	3.148	3.370	3.270	3.575	3.755
7/16/2013	2.630	2.992	3.218	3.137	3.325	3.237	3.525	3.759
7/17/2013	2.630	2.992	3.218	3.137	3.325	3.237	3.525	3.759
7/18/2013	2.630	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
7/12/2013	8.56	8.70	9.10	9.38	9.38	2.75	0.73
7/15/2013	8.55	8.78	9.15	9.38	9.38	2.75	0.73
7/16/2013	8.33	8.68	9.03	9.35	9.35	2.71	0.73
7/17/2013	8.25	8.75	9.05	9.40	9.40	2.79	0.77
7/18/2013	8.10	8.23	8.68	9.13	9.13	2.58	0.77

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
7/12/2013	4.3295	3.3201	3.4928	3.3522	1.4817	0.1666
7/15/2013	4.2922	3.2955	3.4633	3.3022	1.4730	0.1651
7/16/2013	4.2788	3.2735	3.4516	3.2862	1.4623	0.1646
7/17/2013	4.2624	3.2410	3.4492	3.2524	1.4528	0.1640
7/18/2013	4.2453	3.2362	3.4329	3.2300	1.4425	0.1635

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