BRE BANK SA

POLISH WEEKLY REVIEW

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Bureau of Economic Analysis
(research)

Ernest Pytlarczyk, PhD, CFA
chief economist
tel. +48 22 829 01 66
ernest.pytlarczyk@brebank.pl

Marcin Mazurek, PhD
senior analyst
tel. +48 22 829 01 83
marcin.mazurek@brebank.pl

Paulina Ziembinska
analyst
tel. +48 22 829 02 56
paulina.ziembinska@brebank.pl

Piotr Bartkiewicz
analyst
tel. +48 22 526 70 34
piotr.bartkiewicz@brebank.pl

Financial Markets Department
(business contacts)

Lukasz Barwicki
head of trading
tel. +48 22 829 01 93
lukasz.barwicki@brebank.pl

Bartlomiej Malocha, CFA
money market
tel. +48 22 829 01 77
bartlomiej.malocha@brebank.pl

Marcin Turkiewicz
fx market
tel. +48 22 829 01 67
marcin.turkiewicz@brebank.pl

Financial Markets Sales Department
(business contacts)

Inga Gaszkowska-Gebska
institutional sales
tel. +48 22 829 01 67
inga.gaszkowska-gebska@brebank.pl

Jacek Jurczyński
structured products
tel. +48 22 829 15 16
jacek.jurczynski@brebank.pl

Reuters pages:
BREX, BREY, BRET

Bloomberg:
BRE

SWIFT:
BREXPLPW

BRE Bank S.A.
18 Senatorska St.
00-950 Warszawa
P. O. BOX 728
tel. +48 22 829 00 00
fax. +48 22 829 00 33
http://www.brebank.pl

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Comment on the upcoming data and forecasts

Upcoming week is full of macroeconomic data releases. On Monday M3 money supply should reveal continuation of the downtrend due to deteriorating momentum of deposits (corporate deposits might have fallen even by 10% y/y in 2012). On Tuesday we expect CPI to return to the NBP's 2.5% target not only on high statistical base from 2011, but also moderate food prices growth and disinflation of the core basket. On Friday Statistical Office releases data from labor market, industrial sector, and the balance of payments as well. We expect stagnation in employment, which translates to similar -0.3% annual growth rate as in November, wages should drop to only 1.1% y/y growth due to negative working days difference and base effect from 2011. Negative working days effect should determine industrial output as well. Data from recent months point to decerating trend in manufacturing (in both output and employment), which together with weak economic indicators confirms our scenario of Polish economy heading toward recession.

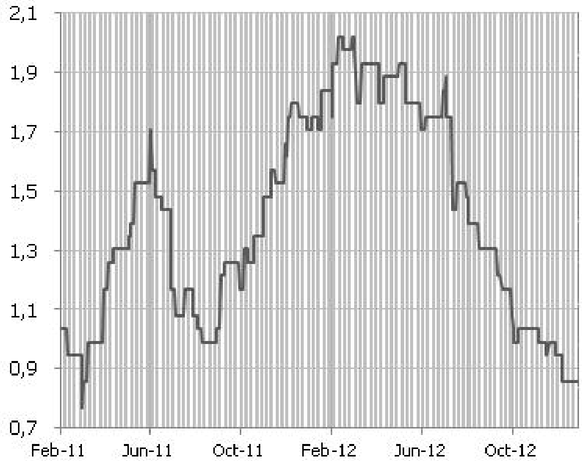
Polish data to watch: January 14th to January 18th

Publication	Date	Period	BRE	Consensus	Prior
M3 y/y (%)	14.01.	Dec	4.1	4.5	5.8
CPI y/y (%)	15.01.	Dec	2.5	2.5	2.8
Industrial production y/y (%)	18.01.	Dec	-9.0	-6.9	-0.8
PPI y/y (%)	18.01.	Dec	-0.6	-0.6	-0.1
Employment y/y (%)	18.01.	Dec	-0.3	-0.4	-0.3
Wages y/y (%)	18.01.	Dec	1.1	2.0	2.7
Current account balance (mln EUR)	18.01.	Nov	-701.0	-802.0	-650.0

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Last yield (%)	Prev auction
52 Week T-bills	-	3600	3.560	1/9/2013
2Y T-bond OK0714	1/23/2013	5000	3.856	10/23/2012
5Y T-bond PS0418	1/23/2013	4000	3.900	11/8/2012
10Y T-bond DS1021	-	4000	3.847	1/7/2013
20Y T-bond WS0429	-	4000	3.896	1/7/2013

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



Comment
Index unchanged after the week with MPC decision only. Some negative surprises to be expected on next Friday.

* 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

- Consensus view on the Polish economy still too optimistic (we expect more growth forecasts downgrades along with further deterioration in high frequency data).
- We expect Polish economy to enter recession in H1 2013 (negative GDP growth in y/y terms). External developments (meager growth in Germany, zero growth in euro zone) are not dynamic enough to offset deceleration in domestic demand. Consumption growth close to zero (zero savings rate, deleveraging urgently needed), negative investment growth rate (public investment as an original damper to growth, private investment to dip into negative territory soon on weak demand prospects), restrictive fiscal policy.
- We find it hard so far to pin down factors facilitating a rebound in H2 2013. A faster re-acceleration of the euro zone economy seems to be the most obvious one as we leave government programs aside (given time lags in their implementation). However, given the scale of slack in investment and consumption any rebound generated this way cannot be a meaningful one. 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. GG deficit no higher than 4% (minor impact for the economy, support for Polish bonds).
- Inflation set to moderate in the near term on statistical effects (high base from 2012) and in mid-term on lower core inflation (close to 1% in mid 2013). CPI inflation at below 2.0% in January 2013. The possibility for significant undershooting of inflation target in 2013 is high.
- Monetary easing cycle started already in November. MPC is backward-looking so we expect rates to fall to 3.25%, as soon as weaker economy leaves its print on inflation. Rising real interest rates make further interest cuts look easier, so does strong zloty.

Financial markets

- 2013 most likely not a ”bond year”. Global ”rotation” of assets poses headwind for debt.
- Polish bonds clearly more sensitive to core markets developments. It is also more clear that global recovery (or monetary stimulus withdrawal) and rising core yields (ECB ruling out refi rate cuts, Fed discussing exit strategy) may adversely affect Polish bonds as well.
- Fundamental reasons for lower yields in Poland (much lower inflation and growth, monetary easing, carry trades, yield pickup, credit risk well contained) stay intact. As the ongoing C/A rebalancing may be rating positive, the process should provide additional support for Polish bonds.
- We still expect POLGB’s to stay at historically low levels. DM funds are pushed for more diversification and are faced with lower high grade issuances. Therefore compression in intra euro spreads should not be critical for Polish bonds.
- Cyclical behavior of the Polish zloty far weaker than in 2008-2011 as current account has been narrowing and euro zone disintegration risks were put aside with ECB put. Hence we expect only slight weakening of the zloty with 4.22/25 (technical analysis) acting as a hard resistance.
- Volatility on both FX and FI lower due to so-called ECB put.

BRE forecasts

	2008	2009	2010	2011	2012 F	2013 F
GDP y/y (%)	5.1	1.6	3.9	4.3	2.1	0.5
CPI Inflation y/y (average %)	4.3	3.5	2.8	4.2	3.7	1.7
Current account (%GDP)	-5.3	-1.6	-4.5	-4.9	-2.6	-2.0
Unemployment rate (end of period %)	9.5	12.1	12.4	12.5	13.3	14.2
Repo rate (end of period %)	5.00	3.50	3.50	4.50	4.25	3.25

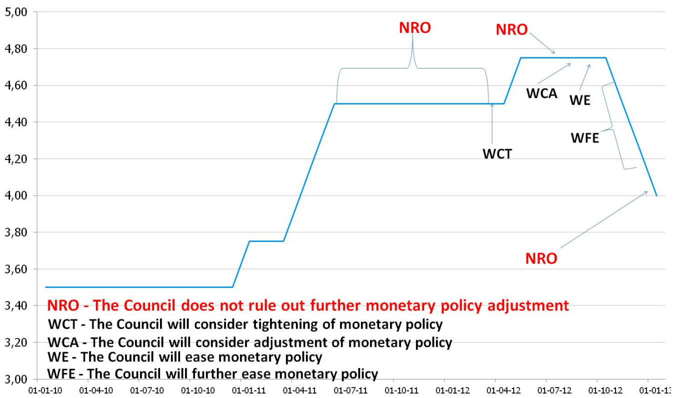
	2012 Q1	2012 Q2	2012 Q3	2012 Q4 F	2013 Q1 F	2013 Q2 F	2013 Q3 F	2013 Q4 F
GDP y/y (%)	3.6	2.3	1.4	0.7	-0.7	-0.2	0.9	1.9
Individual consumption y/y (%)	1.7	1.2	0.1	-0.2	0.2	0.5	1.0	1.5
Public Consumption y/y (%)	-0.8	0.5	0.2	0.0	1.0	1.0	1.0	1.0
Investment y/y (%)	6.0	1.3	-1.5	-4.0	-6.0	-5.0	-5.0	-3.0
Inflation rate (% average)	3.9	4.0	3.9	2.9	1.8	1.5	1.5	1.8
Unemployment rate (% eop)	13.3	12.4	12.4	13.3	13.2	13.3	13.5	14.2
NBP repo rate (% eop)	4.50	4.75	4.75	4.25	3.75	3.25	3.25	3.25
Wibor 3M (% eop)	4.94	5.13	4.92	4.11	3.65	3.30	3.30	3.30
2Y Polish bond yields (% eop)	4.62	4.60	4.05	3.14	3.10	3.10	3.20	3.30
10Y Polish bond yields (% eop)	5.50	5.15	4.69	3.74	3.70	3.70	3.90	4.00
EUR/PLN (eop)	4.15	4.22	4.12	4.08	4.10	4.10	4.00	3.90
USD/PLN (eop)	3.11	3.35	3.20	3.09	3.08	3.04	3.08	3.00

F - forecast

Economics

MPC cut rates by another 25bp., but surprisingly did not rule out a break in the easing cycle

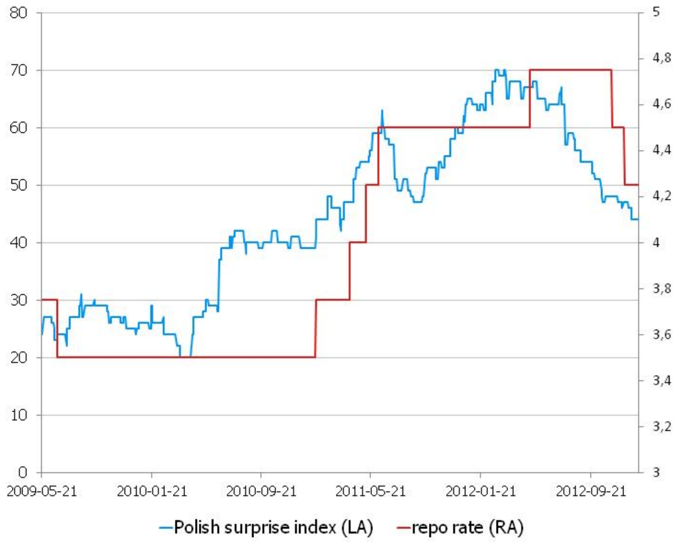
In line with market expectations MPC decided to cut interest rates by 25bp. and revealed rather gloomy assessment of economic activity. The most surprising part of the statement was a change in the last sentence regarding possible future decisions - from the December statement: „Should the incoming data confirm a protracted economic slowdown and should the risk of increase in inflationary pressure remain limited, the Council will further ease monetary policy" the part „will further ease" was replaced in January by „does not rule out further easing". The story of MPC communications reveals that such a change in wording announced an end to at least a part of the cycle or a reversal (see the July 2012 for reference: it was a month when MPC probably realized that being stuck with interest rates cuts was deeply unjustified in the light of the new projection). Therefore the risk of break in the easing cycle has risen significantly. However, given the overwhelming macroeconomic evidence (mind that previous moments of MPC's hesitation were poisoned by macroeconomic dilemmas: high inflation slowing growth or slowing inflation, strong growth; this time such a trade-off is nonexistent) the next MPC's decision depends heavily on the incoming data, which in January will surely confirm „protracted economic slowdown and limited risk of increase in inflationary pressure" (the exact condition from this last sentence of MPC's statement). As we forecast annual drop of retail sales and 9% drop of industrial production in December (data published in January), any break in easing cycle would defend itself (or explicitly: not defend) similarly to May hike.



There is important rift between the statement and the conference which is worth noting. During the conference Belka pointed to still significant probability of rate cut in February (even after better data releases in January or as a prelude to break in March) and highlighted that any break would end only the first round of monetary easing and not the whole cycle. One might even got an impression that Belka wanted to justify contrast with deeply pessimistic economic outlook and rationalize complicated situation among MPC members (some of them tend to stick to their previously chosen „monetary policy rule" and seem to neglect dynamic changes in the economy). Therefore interpretation of this surprising change in MPC rhetoric, which is completely inconsistent with the one from the previous month (just to remind remarks that „MPC cannot afford break in the easing cycle" or Belka voting in favour of 50bp. cut in November), may be running counter the Polish cycle.

Markets reacted abruptly - some investors pointed even to game change in Poland, which highlights their attention not only to risks of deeper economic slowdown, but also to MPC's complicated reaction function (or non-economic rifts within the MPC). We think investors minds may also be busy with processing the effect of changes in ECB communication on the MPC behavior.

We still stick to a scenario of 25bp. rate cut in February (although break in the cycle may take place in the nearest future to please members thinking similarly to Hausner) as strong downtrend on inflation and GDP growth (we are quickly heading towards recession) is going to widen space for further cuts and dispel the any determination to end the easing cycle. However, we are well aware that global environment of higher rates is going to discourage investors to bet on an aggressive easing cycle in Poland, but not necessarily discourage the MPC to deliver. The latter is supported by the latest comments made by governor Belka regarding excessive foreign involvement in financing Polish debt and too high yields of bills discouraging local banks from investing. This draws a picture of a pragmatic governor, who sees greater role of central bank in supporting stability of Polish debt financing.

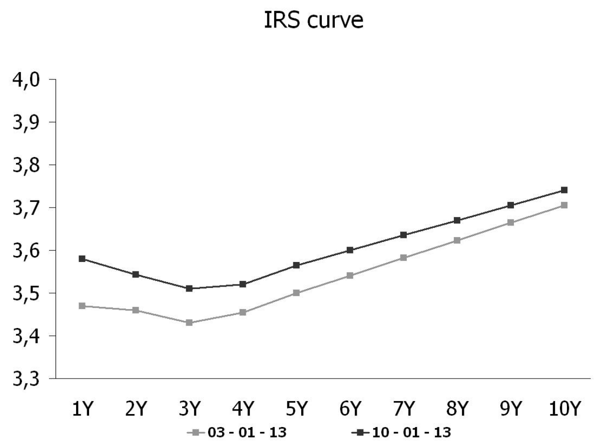


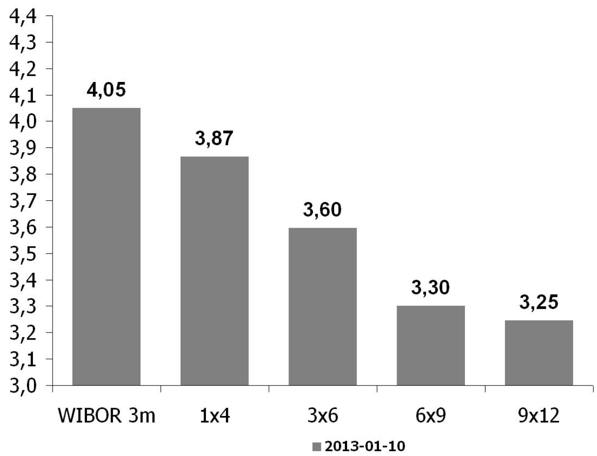
Fixed income

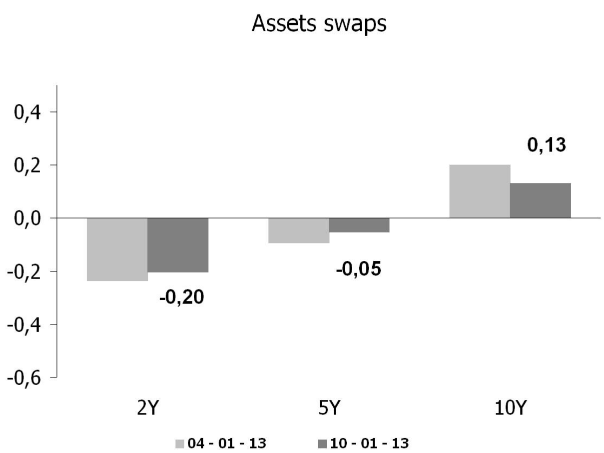
RPP surprises again...

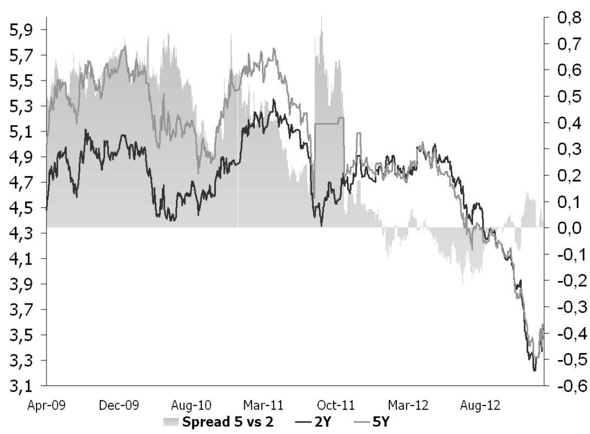
Although the 25bp interest rate cut on the Wednesday RPP meeting was broadly expected, the press conference turned out to be a real earthquake. The market priced off around 20-25bp from the historic lows trading front-end FRA contracts 25bp up and 2y from 3.35% to 3.55% with a slight flattening in the long end. The statement indicated that the Council was ready to cut rates again but diluted conditions for cutting (if economy and inflation behaves then MPC „may ease" instead of "eases further"). Moreover it stressed the easing 'round' might come to its end in the near future. Historically such wording suggested a pause on the following meeting. On the other hand, with data coming in it seemed hard to see how RPP would explain leaving rates on hold with CPI in target and production falling close to -10% yty. The hold may come in March, but that also will be hard to see, as CPI may be below 2% already. But anyway, the market should cease to speculate on a possible acceleration.

As the MPC proved to be more eager to raise rates then lower them, the new scenario should be adopted at this point. The implication of being permanently behind the curve (the repo rate should come at 3.50% already) could lead to the deeper slowdown in the second half of a year (lower than expected revenues) and the higher then expected budget borrowing costs. That would very likely make the 2013 budget revision inevitable. We expect another 50bp monetary easing till March and a longer pause then that would easily make the forward rates more positive along both short and long end. Speculating on a second round of an easing cycle in Q3 might prove to be very dangerous now for if the Council was forced to enter an additional short cycle it would mean it completely neglected the current economic data projections and could stay behind the curve till the end of its mandate. If that happens we could expect the deeper and longer lasting economic slowdown accompanied with the steepest yield curve ever.





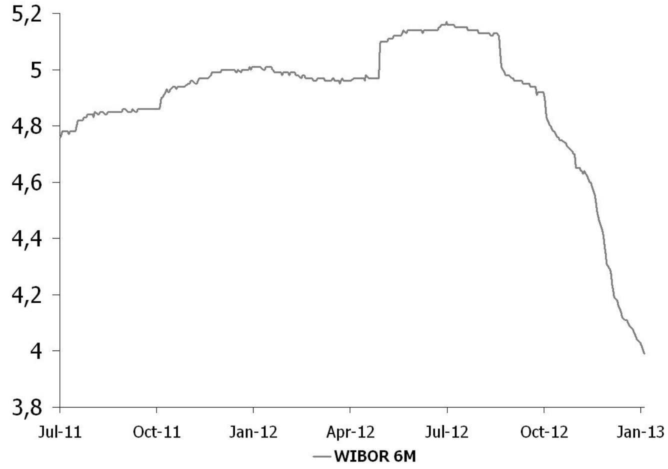


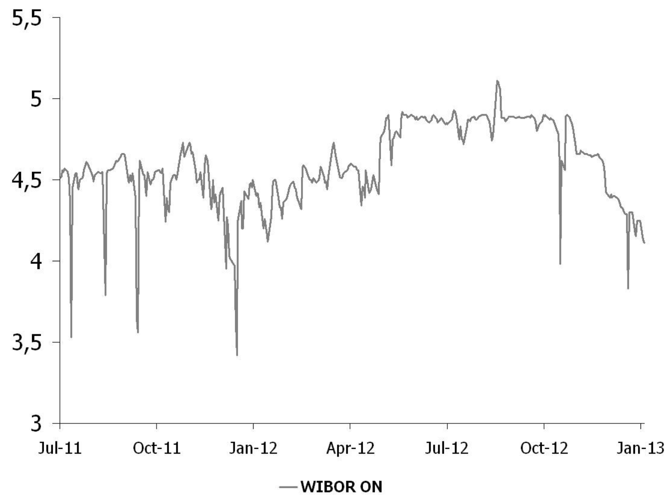


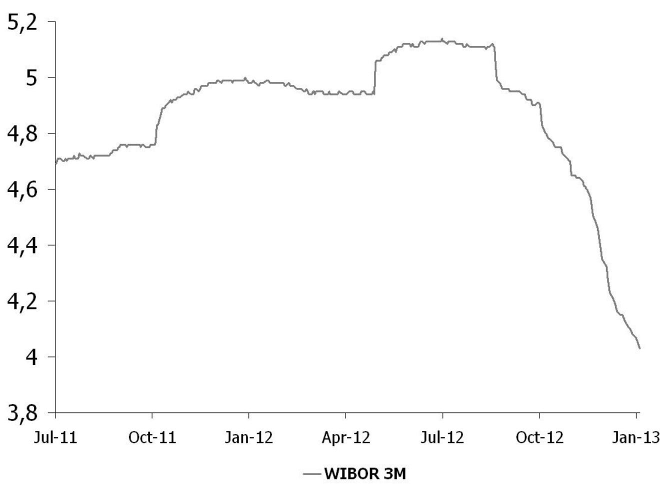
Money market

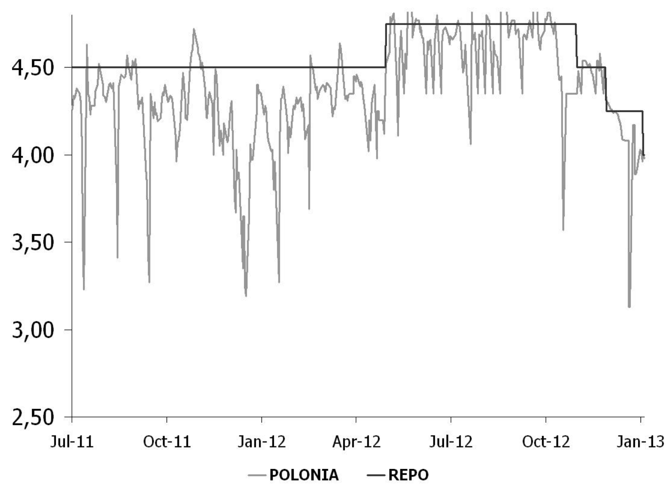
More liquidity in the system Substantially lower demand for money bills (124 bln pln vs 130.5 bln pln on the offer) should push the shortest rates a bit down next week unless additional OMO is held on Tuesday). From the OMO size, we can draw conclusion that system liquidity has grown again.

Hawkish conference after the cut Longer rates moved up about 20 bps after pretty hawkish MPC conference. They cut the rates, however said that this round of easing heads to an end. Since the market saw the reference rate below 3% now its more at 3.25% at the end of the cycle. This may not change even after very weak figures coming on 18th of January and also after quite low CPI reading on 15th. Right now market sees the pause in February, which if happens after such bullish data can be read as another policy mistake. This makes this MPC body really unpredictable and having tendency to stay substantially behind the curve. Therefore, the curve may stay higher or even go further up.







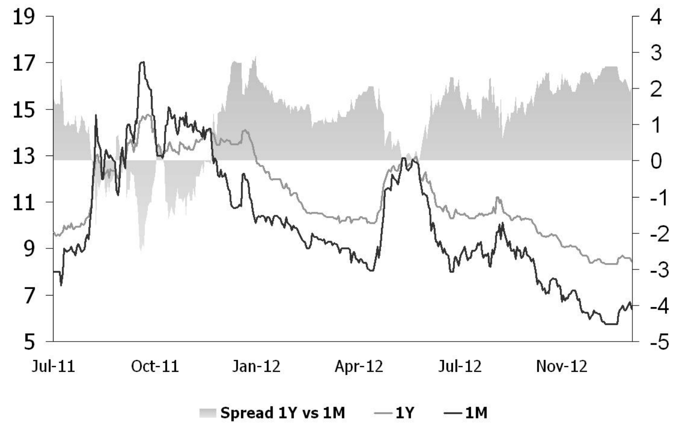


Forex

Range The 25 bp rate cut was highly anticipated and did not influence the EUR/PLN at all. The CB Governor Marek Belka comment on the press conference that „bias change possible in the coming months" put fire under the PLN. As the result the EUR/PLN gapped lower from 4.11 level to 4.0655 low. After the consolidation period, the cross managed to clime back above 4.10. A storm in the glass, one can call it, and the market is still respecting the well defined range of 4.06/4.13.

Slightly lower Stable spot was the main reason why the EUR/PLN vols were a touch better offered this week. On the weekly basis we are roughly 0.2% lower for a front and middle of the curve, 1 month EUPLN ATM is now 6.5 (0.25 lower), 3 months EUPLN ATM mid is today 6.8 mid (0.2% lower), 1 year EURPLN ATM mid is 8.6 unchanged from the last week. The currency spread (deference between USD/PLN - EUR/PLN vol) was heavily offered and is now roughly 0.25 lower from the last week. The Skew also found sellers, the risk reversal run moved lower roughly by 0.2%.

EURPLN volatility



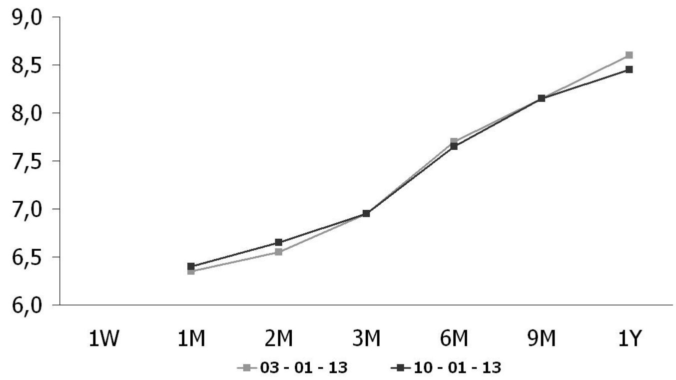
Short-term forecasts.

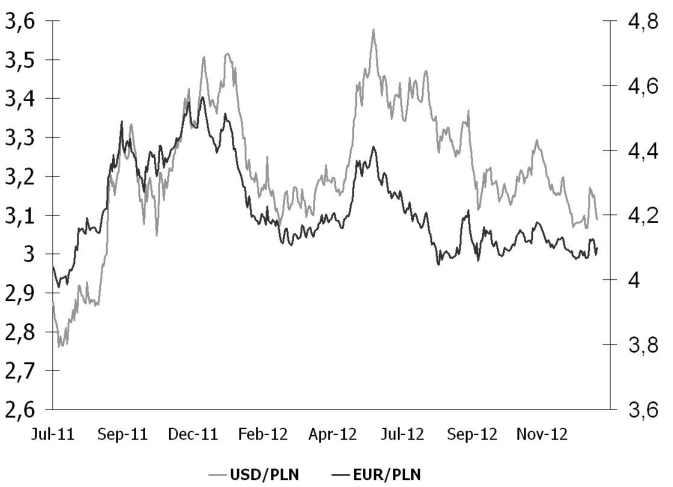
Main supports and resistances
EUR/PLN: 4.0550 / 4.1300
USD/PLN: 3.0600 / 3.2000

Spot The play the range approach is still intact. Fade the extremes, on the both sides of the sides the range. Ideally we would like to sell EUR/PLN at 4.1300 with stop above 4.1500 or buy EUR/PLN at 4.0650 with a stop bellow 4.0450 and hopes for a return to the middle of the range, roughly 4.1000.

Derivatives Unchanged from the last week. The vols are consolidating at the new „Post Lehman" lows. The main/leading currency pairs i.e. EURUSD curves are in the same situation. It may look cheap, but realized volatilities are not really encouraging to rush to buy it.

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
1/4/2013	3.93	4.08	3.81	6.49	3.63	6.59	3.83	3.48	3.17	3.15	3.19	3.19
1/7/2013	3.85	4.07	3.68	3.93	3.53	3.83	3.78	3.43	3.12	3.10	3.13	3.16
1/8/2013	3.85	4.06	3.78	3.92	3.64	3.82	3.76	3.46	3.07	3.03	3.07	3.11
1/9/2013	3.85	4.05	3.75	3.91	3.61	3.80	3.92	3.56	3.29	3.22	3.27	3.32
1/10/2013	3.87	4.04	3.74	3.90	3.64	3.78	3.87	3.60	3.30	3.25	3.26	3.36

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
1/4/2013	6.590	3.353	3.292	3.275	3.420	3.351	3.630	3.873
1/7/2013	3.830	3.114	3.263	3.148	3.370	3.270	3.575	3.755
1/8/2013	3.820	2.992	3.218	3.137	3.325	3.237	3.525	3.759
1/9/2013	3.800	2.992	3.218	3.137	3.325	3.237	3.525	3.759
1/10/2013	3.780	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
1/4/2013	6.50	7.10	7.75	8.60	8.60	3.22	0.72
1/7/2013	6.60	7.10	7.75	8.60	8.60	3.22	0.72
1/8/2013	6.70	7.15	7.75	8.60	8.60	3.22	0.72
1/9/2013	6.40	6.95	7.65	8.45	8.45	3.11	0.72
1/10/2013	6.40	6.95	7.65	8.45	8.45	3.11	0.72

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
1/4/2013	4.1248	3.1700	3.4106	3.5948	1.4184	0.1628
1/7/2013	4.1218	3.1618	3.4094	3.6022	1.4169	0.1619
1/8/2013	4.1263	3.1457	3.4123	3.5981	1.4108	0.1616
1/9/2013	4.1192	3.1516	3.4075	3.6009	1.4128	0.1614
1/10/2013	4.0760	3.1121	3.3718	3.5295	1.4066	0.1586

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