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Table of contents

Comment on the upcoming data and forecasts

In the forthcoming week there is only the inflation expectations release scheduled. As usual they are expected to follow recent CPI reading. Since the inflation in September remained stable, we forecast that the October inflation expectations will increase slightly to 1,1

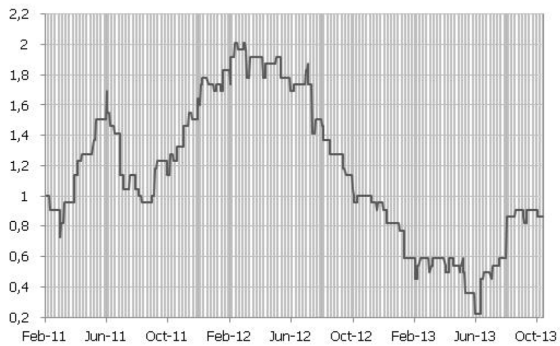
Polish data to watch: October 28th to November 1st

Publication	Date	Period	BRE	Consensus	Prior
Inflation expectations	31.10	Oct	1.1	1.1	1.0

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
52 Week T-bills	-	3000	3.485	3/4/2013
2Y T-bond OK0116	-	6000	3.065	10/22/2013
5Y T-bond PS0718	-	3500	3.819	10/3/2013
10Y T-bond DS1023	-	2000	4.302	10/22/2013
20Y T-bond WS0429	-	150	3.464	5/16/2013

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



Comment

Unchanged. Although the retails sales disappointed, the surprise was not significant enough to move the index. Forthcoming week brings no opportunities for a surprise, since there is only the inlfation expectations release scheduled.

* 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

Our view in a nutshell

Fundamentals

- Available data confirm that the long-awaited recovery began at the turn of Q2/Q3.
- The upswing is driven by a rebound in real income and recovering private consumption. Low rates trigger rotation in households assets towards overnight deposits. Given the scale of slack in investment (infrastructure in particular) and consumption, rebound generated this way may be initially moderate as measured by historical standards. Better business activity in the euro zone is going to strenghten the upswing trajectory.
- H2 is going to be substantially better than H1. Q3 already close to 1.5% and the possibility of exceeding 2% in Q4 monotonically rises. Such a growth is 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. The European Commission gave the government two additional years to bring the GG deficit down to 3%, and a budget amendment (at PLN +16 bn) was just passed. Furthermore, additional boost to public finances comes from the pension reform. This - along with the political 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. 0.2% inflation growth was the lowest in the cycle. Although inflation stays subdued, a new uptrend has began. We expect 1.5% by the end of the year and inflation target is going to be reached in mid 2014.
- Rebound in growth and inflation practically erases easing bias in MPC, as rates have been pun on hold at least until end-2013. We expect first rate hikes to materialize in late 2014 and think that NBP projections of both GDP and inflation for 2014 are be too pessimistic.

Financial markets

- Short term, it is wise to stay constructive on Polish bonds due to (temporary) global reinstalation of QE-induced carry trades. However, unleashed volatility suggests the potential gains are rather limited which is consistent with the amount of risk foreign investors wish to hold in current circumstances.
- Short rates, we think, are close to the absolute floor.
- In the mid term Polish local factors including economic upturn and liquidation of OFE assets suggest higher liquidity risk premium on Polish bonds. Global recovery and rising core yields will additionally adversely affect Polish bonds.
- Zloty capped by risk of NBP FX intervention. It should gradually strenghten on the back of cyclical recovery in Poland.

BRE forecasts

	2009	2010	2011	2012	2013F	2014F
GDP y/y (%)	1.6	3.9	4.5	1.9	1.3	3.2
CPI Inflation y/y (average %)	3.5	2.8	4.3	3.7	1.1	2.2
Current account (%GDP)	-1.6	-4.5	-4.9	-3.5	-1.9	-2.6
Unemployment rate (end of period %)	12.1	12.4	12.5	13.4	13.5	13.2
Repo rate (end of period %)	3.50	3.50	4.50	4.25	2.50	3.00

	2013 Q1	2013 Q2	2013 Q3 F	2013 Q4 F	2014 Q1 F	2014 Q2 F	2014 Q3 F	2014 Q4 F
GDP y/y (%)	0.5	0.8	1.6	2.1	2.6	3.0	3.4	3.7
Individual consumption y/y (%)	0.0	0.2	1.2	1.9	2.2	2.3	2.3	2.4
Public Consumption y/y (%)	-0.5	3.9	3.0	2.0	0.3	0.3	0.3	0.3
Investment y/y (%)	-2.0	-3.8	-1.0	1.0	1.5	2.5	3.5	4.5
Inflation rate (% average)	1.3	0.5	1.1	1.3	1.8	2.2	2.4	2.5
Unemployment rate (% eop)	14.3	13.2	13.0	13.5	14.1	12.8	12.5	13.2
NBP repo rate (% eop)	3.25	2.75	2.50	2.50	2.50	2.50	2.50	3.00
Wibor 3M (% eop)	3.39	2.73	2.67	2.70	2.70	2.70	2.70	3.20
2Y Polish bond yields (% eop)	3.19	3.07	3.05	3.00	3.15	3.30	3.30	3.30
10Y Polish bond yields (% eop)	3.94	4.34	4.43	4.10	4.60	5.00	5.20	5.50
EUR/PLN (eop)	4.18	4.33	4.22	4.10	4.05	3.95	3.90	3.90
USD/PLN (eop)	3.26	3.32	3.12	3.04	2.99	3.10	3.20	3.25

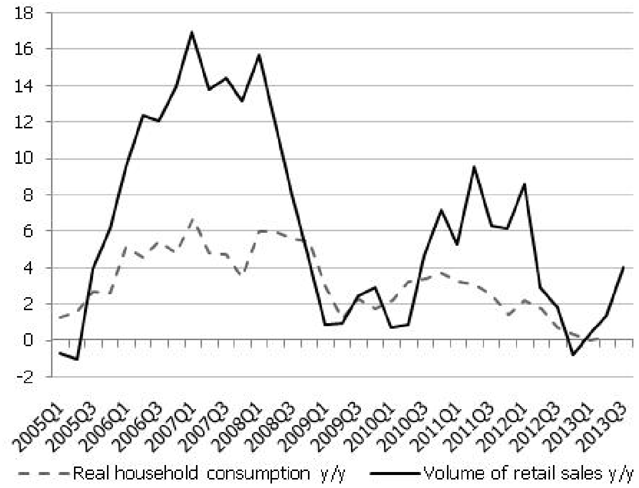
F - forecast

Economics

Retail sales brought down by poor food sales but upward trends are intact

In September retail sales accelerated to 3.9% y/y from 3.4% y/y reported in the previous month (market consensus: +4.6%, our forecast: +5.5%). The somewhat disappointing (considering the favorable working day difference) September reading is a result of very poor food sales. This has been the worst m/m growth of this category (insensitive to working days, by the way) since the Central Statistical Office started to publish retail sales figures using the latest sector breakdown (PKD2007). Excluding food and fuels, retail sales grew by 7.4% y/y in nominal terms and by 8.9% y/y in constant prices. Favorable trends stay intact, then.

Food sales grew by 3.6% y/y (+5.8% in the previous month)... consider that base effects alone should have added +3 pp. to last month's figure. Since household incomes are steadily improving and inflation is low, we are left with no other option but to consider this a one off. Sales of durable goods look much better: car sales accelerated to 17% y/y (11.4% y/y in August), furniture and appliances grew by 5.1% (up from 4.4% in August), clothing surged by 20.3% y/y (+15.0% in the previous month). Such composition is a strong suggestion that positive trends are intact, especially if we take into consideration the fact that consumer credit is thawing out. We expect that consumption will be the second pillar of Polish growth, along with exports, in the early phases of current upswing.



All in all, real retail sales accelerated from 1.3% y/y to 4.0% in the third quarter, strenghtening the case for strong contribution of household consumption in Q3. However, current re-acceleration of household consumption should not result in rising inflationary pressures. Our estimates indicate that demand-driven inflation will begin to appear at the turn of 2014 and 2015. Usual lags in monetary policy transmission, on the other hand, imply that the first rate hike might occur in late 2014. We are still of the opinion, however, that rising inflation in the first half of 2014 (driven by base effects) will fuel market expectations for earlier tightening.

Weaker than expected retail sales figures were broadly neutral for market rates: although initial reaction was negative (yields dropped), a more detailed analysis forced market participants to correct the first move. Zloty somewhat weakened in the aftermath of the release.

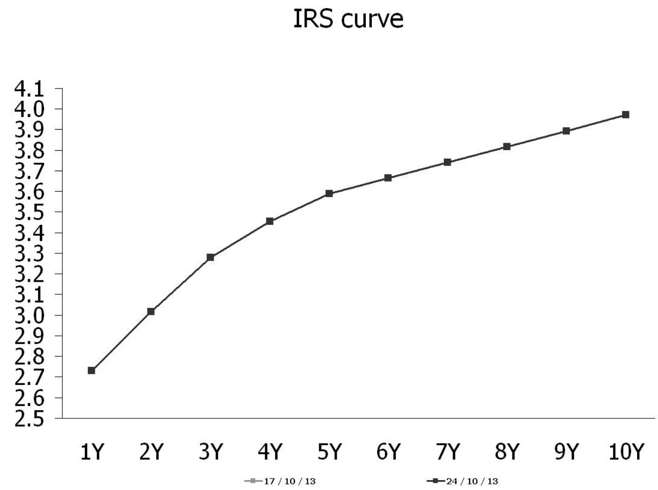
Fixed income

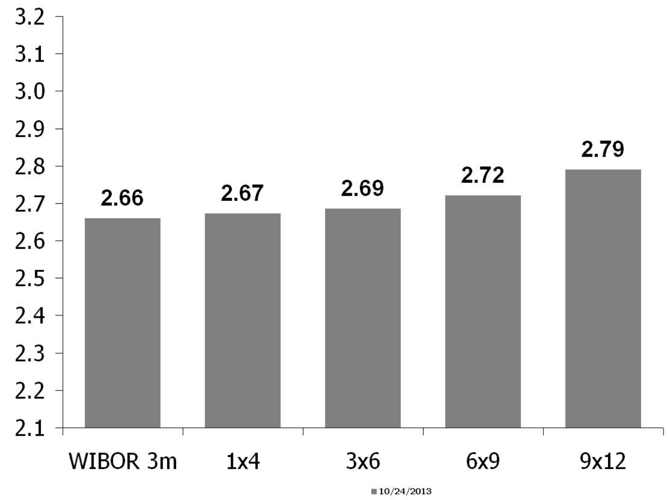
Good auction?

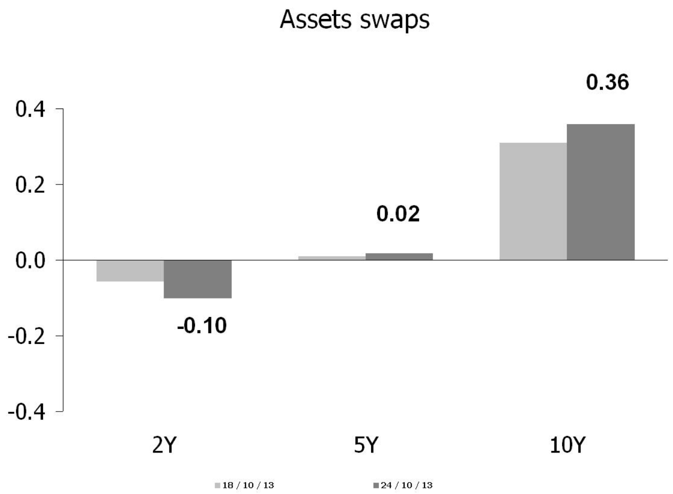
With not so successful previous 2 auctions of PolGBs (low demand and below secondary market prices) market was really nervous at the beginning of this week. One of the biggest (12bln) auctions in the history of Poland was tapped on Thursday. Obviously there was a lot of bonds maturing and a lot of money from coupon payments (around 25bln in total), but still market prices were pushed down significantly just before an auction. Was it a good auction? Generally yes, but mainly because of IZ0823 which found huge demand at relatively low level. Demand for income bonds (OK0116, DS1023) was not so great, considering very good overall global market sentiment.

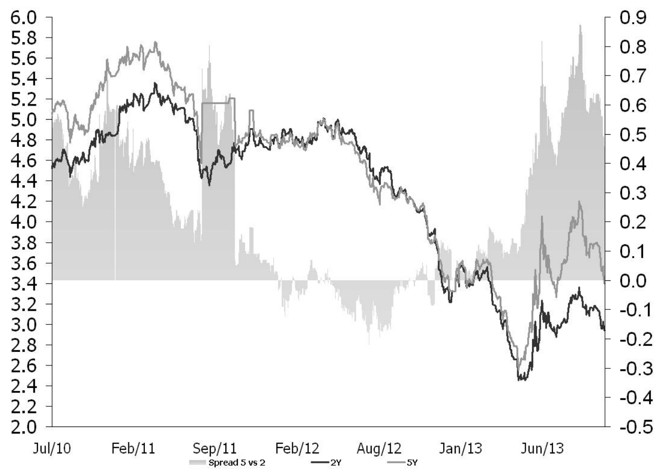
What's next? On rates we came to levels that are not so attractive anymore. Rate hike expectations disappeared, spreads narrowed (2Y10Y down to 90 from 125 bps), bonds got more expensive relative to swaps... If we add the perspective of a next auction (probably PS0718), this looks like a 'profit taking environment'.

Recommendation: Take profit, or even go short on PS0718.





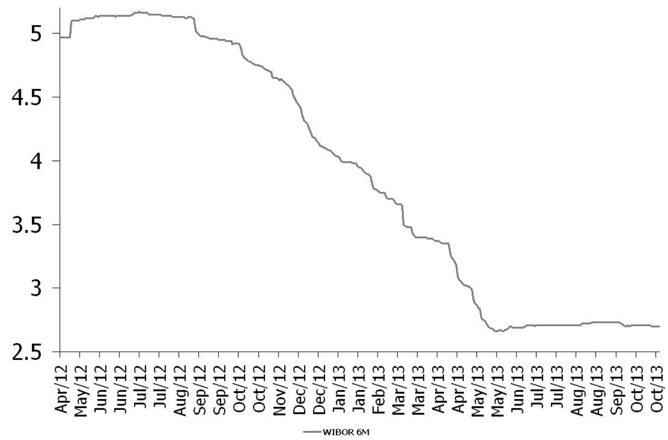


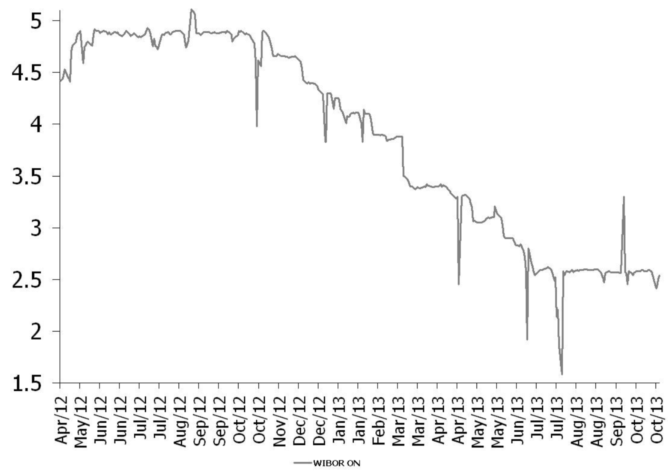


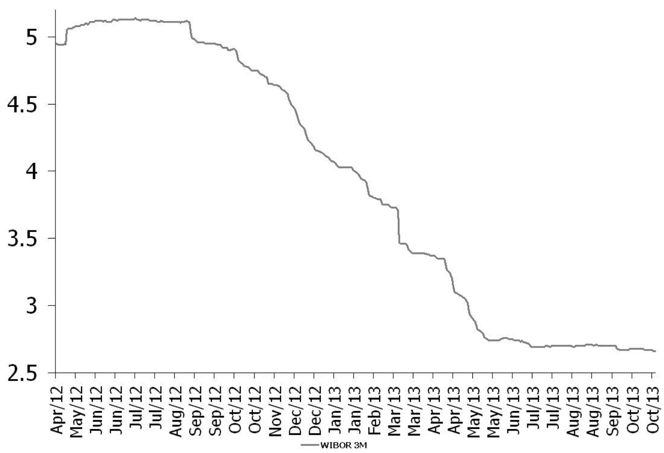
Money market

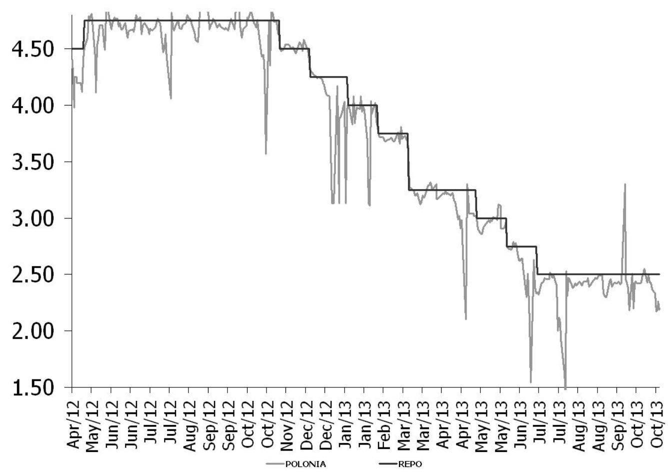
Cheap end of the reserve ahead Very cheap end of the reserve ahead. Low demand during last regular OMO, additional OMO and again today. In our opinion it is simply because of day off next Friday. It is an unjustified behavioural phenomenon for local market that before any holidays risk aversion is growing significantly and the best remedy is to sit on cash. It can be a good example of what is going to happen in December. Selling OIS for those periods is a good opportunity to monetize this phenomenon.

Asymmetric risk/reward profile for front end curve Longer rates massively down after a bullish sequence of weaker retail sales, very good bond auction despite record high supply, some dovish comments from the MPC side plus weaker payrolls from USA. We do not deny that there are no bearish drivers on the horizon, however those levels are really attractive for us to enter the payers (highly asymmetric risk/reward profile). We agree that rate hikes are the story for 4q 2014, but if they start to hike it is not going to be a 50 bps that is discounted in the curve up to 2 years. It is going to be a full cycle of 100-150 bps plus we should build in risk premium for any unexpected events like more OFE reform details or/and tapering boomeranging to the market at the beginning of next year. It seems to be distant future as of now, but can also come unexpectedly to our notice anytime. To sum up we do not share this bullish story, at least not to such extent.









Forex

EUR/PLN in range The event of the week was the delayed publication of NFP, being worse then expected and giving XXX/PLN in general and USD/PLN especially a strong push lower. The rest of the week we have spent consolidating that move, and 4.16 - 4.1950 marked this week's really tight range for EUR/PLN. It is USD/PLN that is much more interesting than EUR/PLN and responsible for PLN getting stronger as EUR/USD creeps higher. We are getting near to the round 3.000 in USD/PLN and we expect same buyers to emerge there, and also the same barrier risk. Trailing after the global sentiment would be our fate...

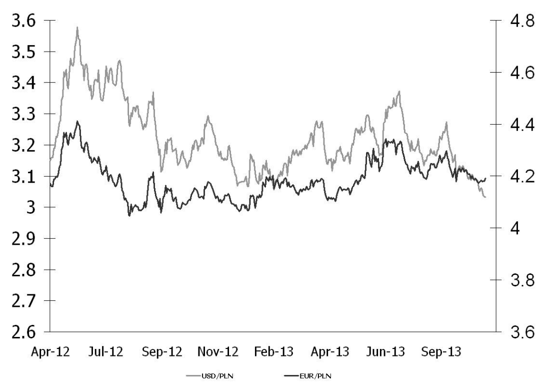
Vols crashed Finally we got to the stage that the sell-off in vols was getting a bit out of control as the vols crashed... 1 month dropped to 6.3% from 6.7% last week, 3 months are now 6.7% (0.5%) lower, 1 year is 8.25% (0.35% lower). The changes may not be that shocking, but one has to note we are just hovering above this year's lows. And the amounts which were traded were impressive: 1 year EUR/PLN ATM given at 8.25% in at least 50 EUR/PLN, 1 year USD/PLN given at 13.75% also in decent amount. All the interests were skewed to the left. The skew was better offered by roughly 0.25% along the curve. The Currency spread (difference between USD/PLN and EUR/PLN vol) also tumbled by almost 0.5%...

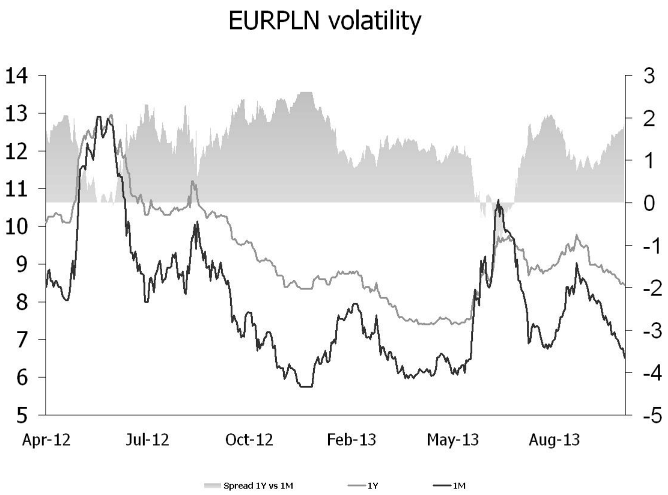
Short-term forecasts

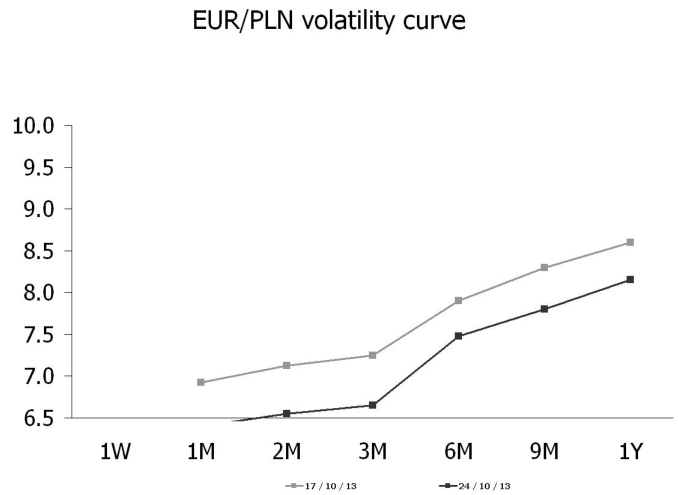
SPOT Main supports / resistances:
EUR/PLN: 4.1450 / 4.2100
USD/PLN: 3.0000 / 3.2000

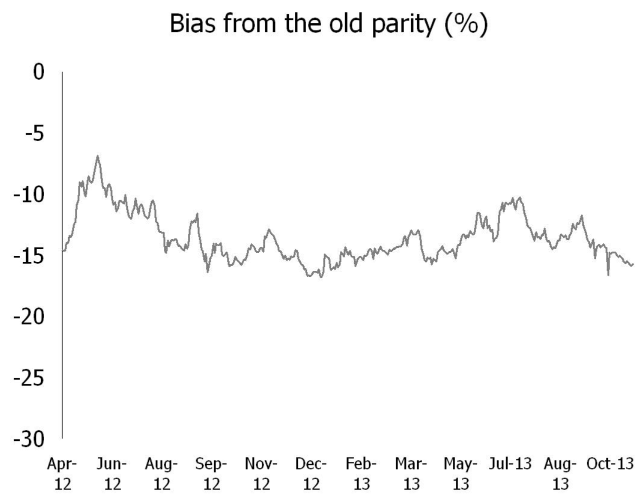
Sell upticks We sold EUR/PLN at 4.1900, we are ready to add 4.21 and set stop at 4.23 with hopes to test 4.1400/4.1450 support level. We have decided to start with 50% of the nominal as we are aware that stops are building above 4.20 level. On the other side the market is so tight that without getting involved relatively quickly, we are risking we will not get involved at all. The postponed tapering should be enough to create same risk really into the year end.

Hold long Vega in Backend We are still long backend EUR/PLN. We have added to the portfolio 1 year EUR/PLN ATM at 8.25%. We agree that delayed tapering in USA creates same space for risk to rally, and for vols to head lower. But not that long ago, most of the marked considered September tapering a done deal and the vols are at the post Lehman lows. It's the vol level that convinced us to add to the position, we don't see any obvious volatility triggers at the moment.









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
10/18/2013	2.36	2.67	2.46	2.60	2.70	2.65	2.71	2.71	2.74	2.81	2.96	2.81
10/21/2013	2.37	2.67	2.49	2.60	2.63	2.65	2.69	2.72	2.75	2.83	3.00	2.83
10/22/2013	2.38	2.67	2.49	2.60	2.72	2.65	2.70	2.71	2.74	2.82	2.95	2.82
10/23/2013	2.36	2.66	2.47	2.60	2.69	2.65	2.68	2.70	2.75	2.85	2.96	2.83
10/24/2013	2.36	2.66	2.46	2.60	2.70	2.65	2.67	2.69	2.72	2.79	2.90	2.80

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
52W TB	3/4/2013	8/28/2013	98.33	3.49	3000	7324	3084
OK0116	10/22/2013	1/25/2016	93.42	3.07	6000	8278	4841
PS0718	10/3/2013	7/25/2018	94.30	3.82	3500	4243	3008
DS1023	10/22/2013	10/25/2023	97.57	4.30	2000	2376	1416

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
10/18/2013	2.650	2.671	2.960	2.904	3.520	3.530	3.950	4.260
10/21/2013	2.650	2.639	3.025	2.913	3.570	3.603	4.000	4.273
10/22/2013	2.650	2.677	2.985	2.900	3.480	3.575	3.910	4.272
10/23/2013	2.650	2.631	2.985	2.841	3.475	3.472	3.900	4.186
10/24/2013	2.650	2.801	2.943	2.842	3.400	3.417	3.826	4.184

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
10/18/2013	6.78	7.20	7.85	8.48	8.48	2.65	0.77
10/21/2013	6.75	7.20	7.85	8.48	8.48	2.65	0.77
10/22/2013	6.78	7.15	7.88	8.50	8.50	2.71	0.78
10/23/2013	6.51	6.88	7.70	8.44	8.44	2.71	0.78
10/24/2013	6.40	6.65	7.48	8.15	8.15	2.71	0.76

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
10/18/2013	4.1769	3.0506	3.3824	3.1172	1.4194	0.1623
10/21/2013	4.1850	3.0620	3.3874	3.1206	1.4249	0.1625
10/22/2013	4.1786	3.0564	3.3827	3.1077	1.4202	0.1621
10/23/2013	4.1800	3.0385	3.3944	3.1246	1.4311	0.1618
10/24/2013	4.1812	3.0323	3.4016	3.1168	1.4250	0.1621

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