Weekly economic update

22 – 28 October 2012

Positive news regarding Greece (this country is close to obtaining next tranche of bailout package), the Moody's decision to maintain Spanish rating at investment grade and very successful auctions of Spanish and Italian bonds were main factors due to which the optimism was more present than risk aversion during the past week. Domestic data confirmed that the situation on the labour market is getting weaker every month and that output clearly decelerates. These releases strengthened expectations for rate cuts by the MPC and on the one hand limited potential for zloty's appreciation (the EURPLN tested the upper band of consolidation after data on the industrial output) while on the other hand they supported short- and medium-term debt (yield of the 5Y benchmark established record low again). On the EU summit the European leaders agreed to prepare a framework on common banking supervision by the end of 2013 and at the beginning of 2014 6000 banks should be under single supervisory authority. Still, there is no agreement among the EU leaders when direct recapitalization of banks will be started. Contrary to some market expectations, Spain did not ask for help but this did not trigger any visible disappointment.

In the coming week investors' attention will focus on indexes of activity in manufacturing. PMI for Germany and the euro zone increased for the last two consecutive months and it will be crucial whether this momentum is continued also in October. We anticipate that the US central bank will repeat main conclusions from September's meeting when the QE3 was launched. This should ensure investors that despite set of better-than-expected data released in the past few weeks the Fed will continue to buy bonds in order to support US economy. Consequently, the outcome of the Fed's meeting may have a positive impact on the global moods. We do not expect domestic data to have such a visible impact on the market as in the previous week. Expectations for rate cuts will continue to prevent the zloty from a more visible appreciation and will still support short end of the bond curve. Main event on the long end of the curve will be auction of new 10Y benchmark.

Economic calendar

TIME CET	COUNTRY	INDICATOR	PERIOD		FORECAST		LAST VALUE
					MARKET	BZWBK	
		MONDAY (22 October)					
14:00	**PL**	**Core inflation**	**Sep**	**%YoY**	**1.9**	**1.9**	**2.1**
		TUESDAY (23 October)					
10:00	**PL**	**Retail sales**	**Sep**	**%YoY**	**4.1**	**4.5**	**5.8**
10:00	**PL**	**Unemployment rate**	**Sep**	**%**	**12.5**	**12.5**	**12.4**
11:00	**PL**	**Bond auction OK0714/DS1023**					
16:00	EZ	Consumer confidence index	Oct	pts	-26.0	-	-25.9
		WEDNESDAY (24 October)					
4:30	CN	Flash PMI – manufacturing	Oct	pts	-	-	47.9
9:28	DE	Flash PMI – manufacturing	Oct	pts	48.0	-	47.4
9:58	EZ	Flash PMI – manufacturing	Oct	pts	46.5	-	46.1
10:00	DE	Ifo index	Oct	pts	101.5	-	101.4
16:00	US	New home sales	Sep	k	385	-	373
20:15	US	Fed decision		%	0.0-0.25	-	0.0-0.25
		THURSDAY (25 October)					
10:30	GB	Flash GDP	Q3	%YoY	-0.5	-	-0.5
14:30	US	Durable goods orders	Sep	%MoM	7.0	-	-13.2
14:30	US	Initial jobless claims	week	k	370	-	388
16:00	US	Pending home sales	Sep	% MoM	2.9	-	-2.6
		FRIDAY (26 October)					
14:30	US	Advance GDP	Q3	%YoY	1.9	-	1.3
15:55	US	Michigan index	Oct	pts	83.0	-	78.3

Source: BZ WBK, Reuters, Parkiet, Dow Jones

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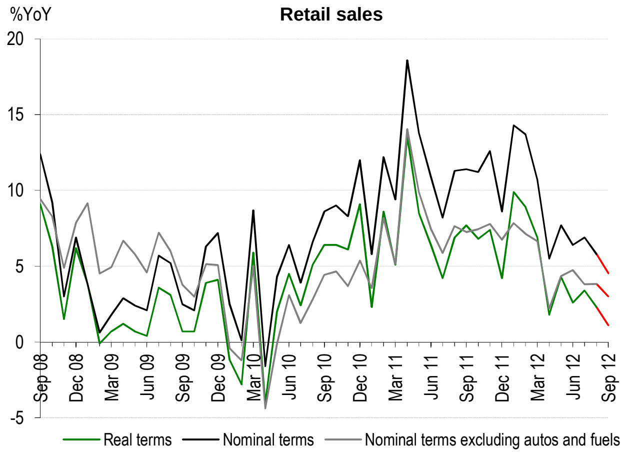
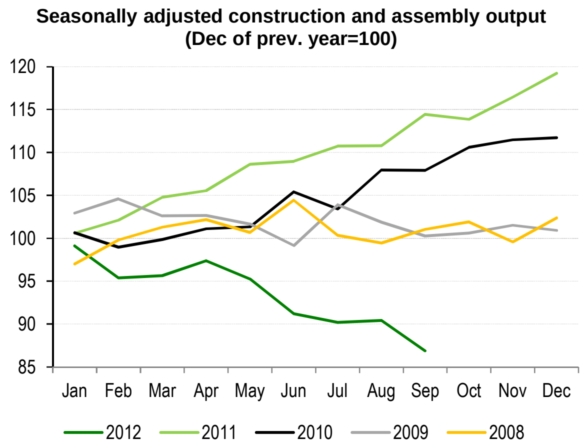
What's hot this week – More weak data from the domestic economy

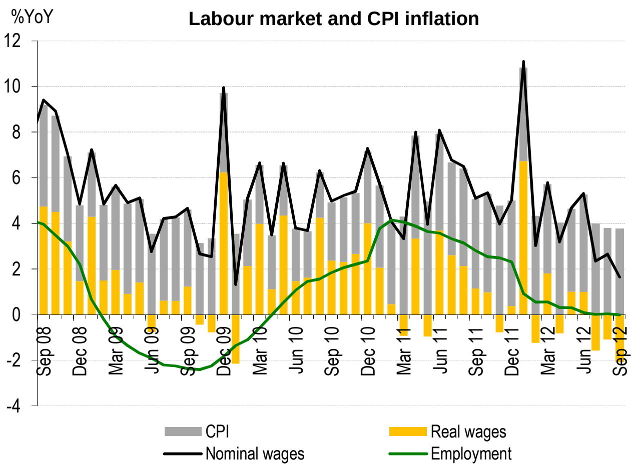


- In our view, retail sales growth decelerated to ca. 4.5%YoY, which is by as much as 10pp lower than in January 2012. We are expecting that real retail sales rose by a mere 1%YoY, which is the lowest reading in more than two years. These data will confirm the downward tendency of consumer demand.
- We are expecting the registered unemployment rate to rise to 12.5% in September from 12.4% in August. Our forecast is in line with estimates of Labour Ministry. In our view the unemployment rate may exceed 13% at the year-end.
- Based on information about breakdown of consumer prices' growth, we estimate that core inflation excluding food and energy prices declined in September to 1.9%YoY from 2.1%YoY in August. This figure is showing the weakness of demand pressure on prices.

Last week in the economy – Plunge in output, miserable data from the labour market



- Output in industry plunged in September by 5.2%YoY and in construction by 17.8%YoY. The September's data were biased down by the effect of two working days less than in September 2011. However, also the seasonally adjusted data show a further deterioration – output in industry fell by 1.6%YoY (a first drop since end of 2009), while construction and assembly output contracted by 9.5%YoY (the strongest decline since April 2005). The upcoming months can show some rebound due to more favourable distribution of working days.
- In August annual growth of imports slowed to -3%, down from +2% in July, while exports slowed down from 10.9%YoY in July to 4.3%YoY in August. Trade gap narrowed to a mere €48m. We expect foreign trade volume to decelerate further in upcoming months.



- In September consumer prices rose by 3.8%YoY (unchanged as compared to August). Fact that inflation rate did not record a temporary increase in September (despite relatively low base from last year) is indicating that outlook for the upcoming months can also be more optimistic than previously expected.
- PPI inflation eased in September to 1.8%YoY from 3.0%YoY in August and is the lowest since April 2010.
- The average number of employed in manufacturing sector reached fell 8k by vs August, while average wage growth decelerated markedly, to 1.6%YoY from 2.7%YoY. The wage bill in manufacturing sector increased by 1.6%YoY in nominal terms (weakest growth since January 2010) and declined by 2.1%YoY in real terms. Data confirmed that there are no signals that demand for labour is recovering.

Quote of the week – Chances for a cut in November rose

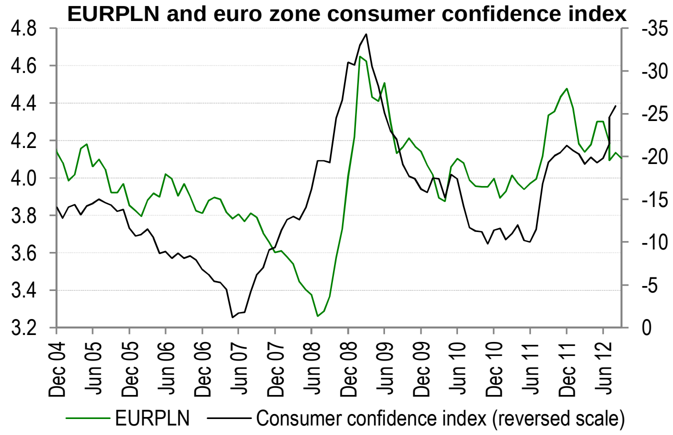
Jan Winiecki, MPC member, 19.10, Dziennik Gazeta Prawna
Chances for a cut in November rose after September's data. Inflation is still close to 4%. That is why rate cuts, no matter if implemented in several small steps or in one more considerable, will not be big.

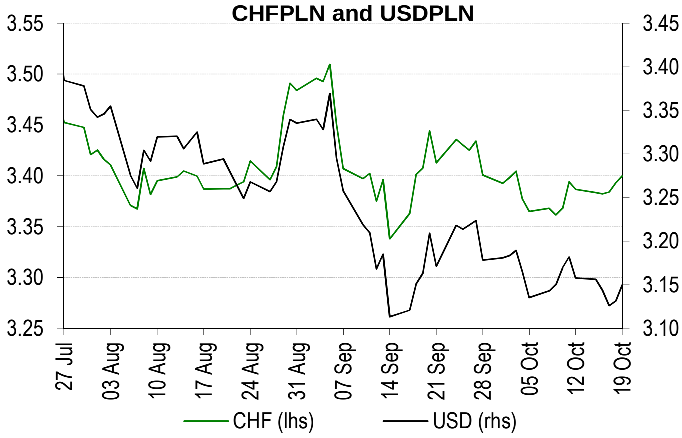
Anna Zielińska-Głębocka, MPC member, 18.10, Reuters
All figures released recently indicate an economic slowdown. Under such circumstances a cut in November is justified and it would constitute a start of a short cycle (…) I am against radical changes in the monetary policy.

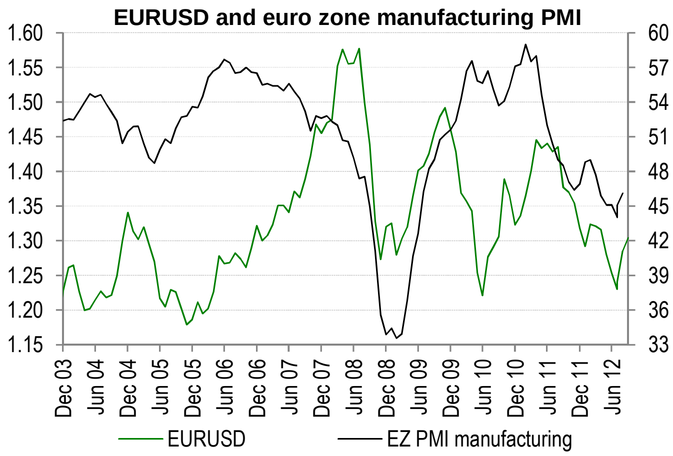
Elżbieta Chojna-Duch, MPC member, 18.10, Reuters
Data on output are a motivation towards decisive interest rate cut in November. I think that should be a cycle. Slowdown is quite strong, this is an argument for monetary policy easing.

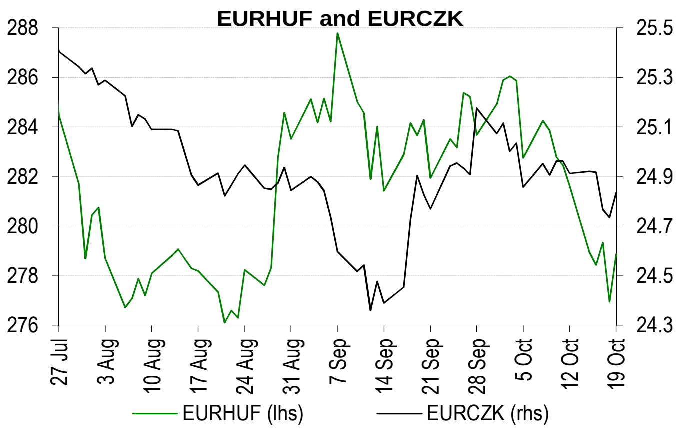
It seems that interest rate cut by 25bps at the upcoming meeting in November is getting more probable. Still, minutes for the October's MPC meeting, released last week, show that some members think that the economic slowdown in Poland will be "moderate and relatively short-lived". In our view J. Winiecki and A. Zielińska-Głębocka represent this camp, as they suggest that the easing cycle will be short and rates will be changed slightly. This means that the market's forecast, which is pricing-in cuts by 100bps, can prove exaggerated. Nevertheless, there is a growing number of MPC members who notice the economic slowdown and view a monetary policy response as necessary. A. Bratkowski and E. Chojna-Duch are in avant-garde of this group and in September they both supported a cut by 50bps.

Foreign exchange market – The EURPLN close to vital resistance









Zloty under pressure of expectations for rate cuts

- Despite a pretty positive market sentiment on the global market during the past week, the zloty lost versus the euro and gained marginally versus the dollar (only due to higher EURUSD). The EURPLN moved clearly up, particularly after data on slightly weaker-than-expected Polish industrial output. Consequently, at the end of the week the exchange rate tested upper band of the consolidation, in which the EURPLN stays since early September.
- The USDPLN declined temporarily to 3.11 as the euro continued to gain versus the dollar at the beginning of the week.
- During the coming week a set of data from the euro zone will be released, including consumer confidence index. The publication of this index will rather not have any direct impact on the market, but chart shows that until there is no stabilization of the situation in the euro zone, it is hard to expect any considerable and long-lasting appreciation of the zloty.
- Though we expect the statement from Fed's meeting to have some positive impact on risky assets (details below), strengthened expectations for rate cuts in Poland constrain the scale at which the zloty may benefit from waves of optimism emerging on the market. Last week the EURPLN was close to very important resistance and the narrowing trading range indicates that soon the exchange rate may leave this consolidation. Direction determined by this event may be valid in coming weeks or even months.

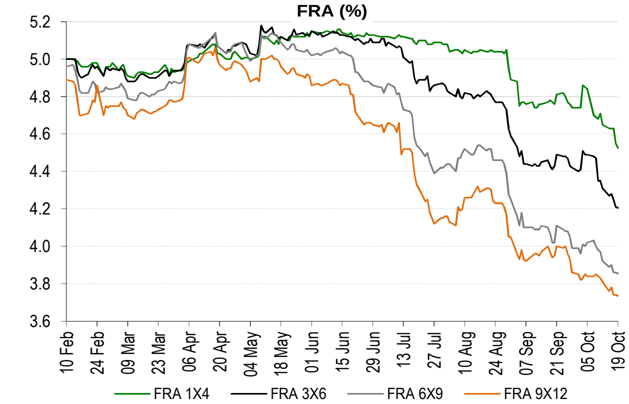
Fed's statement may support the euro

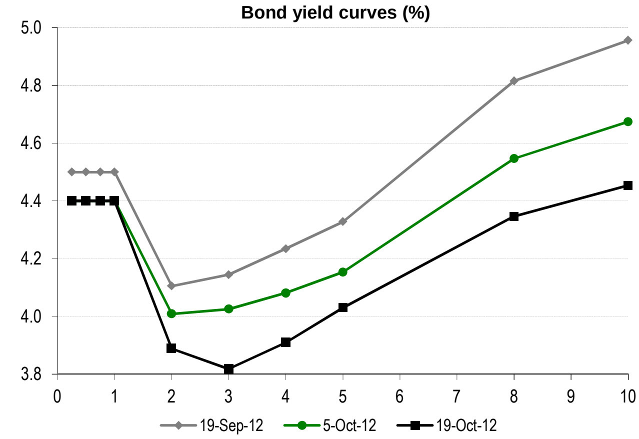
- Positive information regarding the situation in the euro zone and falling yields of Spanish bonds clearly backed the euro at the beginning of the week. The EURUSD advanced above the peak from the beginning of the month (1.307) and temporarily reached 1.314. Slight deterioration of market sentiment dragged the exchange rate back to 1.305 at the end of the week.
- This week flash PMI for German and the euro zone manufacturing will be released. Index for the euro zone plotted on the EURUSD's chart clearly shows that weak economy constrains the potential for higher EURUSD.
- We anticipate the US central bank to repeat main conclusions from September's meeting when QE3 was launched. This should ensure investors that despite set of better-than-expected data released in the past few weeks the Fed will continue to buy bonds in order to support US economy. Consequently, the outcome of the Fed's meeting may have a positive impact on the global moods and provide support for the euro versus the dollar. If the EURUSD does not stay below 1.307 for longer, then in the coming days it may head towards 1.317.

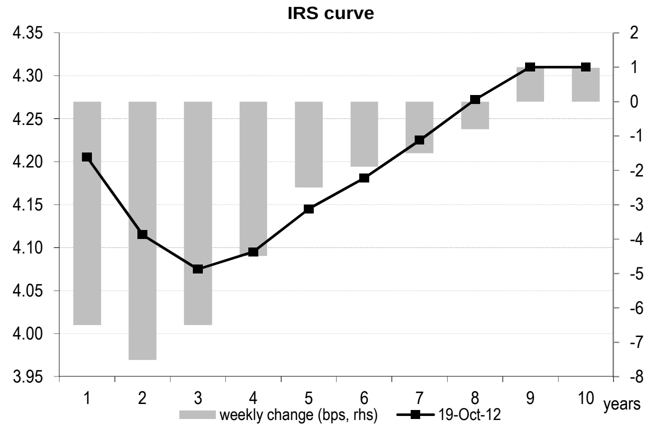
Forint gains on optimism and hopes for deal with IMF

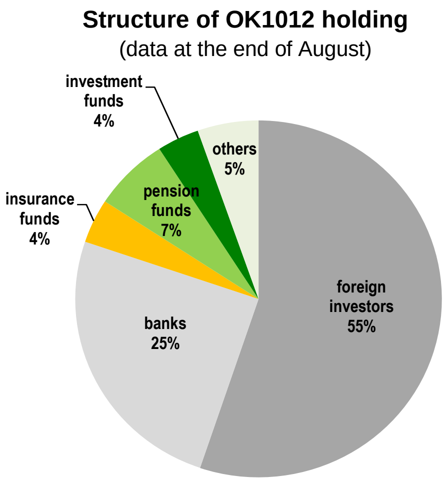
- The EURHUF plunged during the past week slightly below 276, lowest level since late August. Forint was supported by market optimism and hopes that Hungarian government and the IMF will find an agreement on conditions of loan. Similar changes occurred in case of the EURCZK. Czech koruna continued to recover after depreciation initiated by the rate cut. The EURCZK plunged from 25.0 to 24.67.
- Both HUF and CZK pared some part of earlier gains at the end of the week. The EURHUF rebounded to support at 279 and EURCZK to 24.81.

Interest rate market – Lower rates due to expectations of interest rate cuts in November









Intensification of interest rate cut expectations…

- After weaker-than-expected industrial output data hopes for November's rate cut increased significantly. Consequently, WIBOR rates have continued downward move, which also affected FRA quotations. In weekly terms WIBOR fell by 4-6bps, with the highest decrease in the long-term rates (9M and 1Y). One should notice that since the Q2 GDP data release WIBOR rates have gone down by 33-35bps for rates 3M+. Regarding FRA market, rates declined by 6-13bps compared to previous week, with the highest decrease in case of 1x4 and 3x6.
- This week's data releases (retail sales, core CPI measures) should confirm weakening of domestic demand and low inflation pressure. These data might stabilize market expectations on interest rate cuts in coming months. Currently, market is pricing-in monetary easing by 50bps in 3 months' period and by slightly more than 100bps in 9 months' horizon.

…supported also the front and mid of the curve

- Published macro data have also supported the front end and mid of bond and IRS curves. During the week yield of 2Y fell to 3.89% (the lowest level in history), after the decline by 9bps in weekly terms. Yield of 5Y also reached a new all-time low (near 4.03%). As a result 2-5Y spread narrowed to 14bps, down from weekly maximum at 21bps.
- Changes in IRS rates in 1-5Y sectors were less considerable as compared with bond market. In weekly terms they declined by 2-7bps, with the highest scope of downward move for IRS1Y and IRS2Y.
- 10Y sector was under pressure of investors' mood on the core markets. Due to risk-on sentiment investors shifted their capital from safe-haven instruments to more risky ones. As a consequence, yield of 10Y Bund increased and domestic 10Y sector has followed this move. However, it was only short-lived. The end of the week brought further strengthening of 10Y bond. Yield broke support level at 4.50% and declined to 4.45%, the lowest level since 2005.

Auction and redemption influence investors' mood

- This week the main event on the bond market will be auction of 2Y benchmark OK0714 and a new 10Y bond DS1023. The auction will take place on Tuesday (23.10), which is rather unusual, with a settlement date on Thursday (25.10). The Ministry of Finance will offer bonds worth PLN6.0-9.0bn (vs PLN5.0-9.0bn planned initially). Liquidity situation (this week funds worth PLN25bn from redemption of OK1012 and coupon payments are flowing to the market) should support strong demand at the tender.
- The Polish debt performance on both the domestic and foreign markets allows the Ministry of Finance to change issue conditions of DS1023. As a result the MF decreased coupon for the new series to 4.00% (down from 5.75% for DS1021). We believe that this level is still very attractive for investors, especially foreign ones taking into account that financial costs are very low (near zero for both € and the US dollar).
- Last session showed that changes in 2-10Y spread are oscillating between 55 and 85bps, depending on global mood. As we mentioned earlier 2-5Y spread narrowed and we think this tendency could continue in coming days. The important support level for spread is 10bps.

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