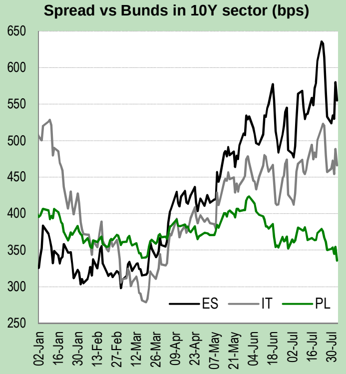
Bank Zachodni WBK

# Rates and FX Outlook

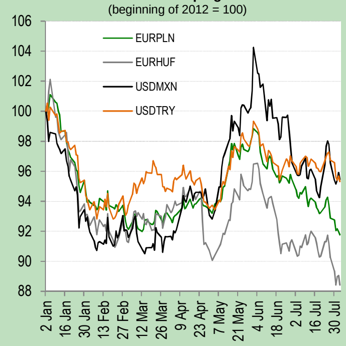
## Polish Financial Market

August 2012

Spread vs Bunds in 10Y sector (bps)




Currencies of developing economies
(beginning of 2012 = 100)




- **The ECB governor's statement that the bank is "*ready to do whatever it takes to preserve the euro. … Believe me, it will be enough*" has revived expectations for a quick action by the ECB to support the euro zone peripheries. However, the Council meeting at the start of August failed to deliver the clarity, immediacy and decisiveness of action that some had hoped for.** Nonetheless, the ECB has declared a willingness to support peripheries, concentrating mainly on the short end of the yield curves, but emphasized that euro zone's countries should still provide fiscal consolidation and implement necessary reforms. Disappointment after the ECB proved to be short-lived. Global mood has remained still positive, supporting risky assets including the zloty. The EURPLN has continued downward move, breaking support levels and approaching towards 4.00, a strong psychological level. In August investors will focus on Q2 GDP data releases for the euro area, which could create some impulse for the market.
- **The Monetary Policy Council has no decision-making meeting in August, while at the last meeting in July it maintained its "wait-and-see" mode, not ruling out further policy tightening. In the meantime, a set of weak data from domestic economy published recently has triggered some softening of tone of the Council members' comments.** One should notice that some MPC members have suggested that the Council should consider rate cuts, including a possibility of voting a motion for a rate cut in September. Taking into account that CPI inflation would stay above 4%YoY till late-autumn, we expect the official rate to stay unchanged till year-end. Nevertheless, the market participants strongly believe in interest rate cuts in coming months. Currently, FRA market is pricing-in monetary policy easing by 100bps in 9 months horizon, with the first cut by 25bps to be delivered in Q4 2012. We are more cautious in our baseline scenario, expecting stable rates till the end of the year. However, Q2 GDP data, which will be published at the end of August, could be crucial.
- **We expect the financial market to remain vulnerable to upcoming macroeconomic data (mainly Q2 GDP readings) and ahead of September's central bank meetings.** We expect the EURPLN to test psychological support level at 4.00 in coming days/weeks. If it is broken, the EURPLN will continue downward move towards the next support at 3.90. Polish debt still is optimal alternative for foreign investors. Strong demand from non-residents together with low supply of Treasury securities and expectations for interest rate cuts later this year have pushed yields down to this year's new lows. However, some rebound of macroeconomic data, which will be published later this month, might create some impulse for correction, but in our opinion it will be only short-lived.

*This report is based on information available until 3rd August*

**Table of contents:**



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# Short- and Medium-term Strategy

## Interest rate market

| | Change (bps) | | Level | Expected trend | |
|---|---|---|---|---|---|
| | Last 3M | Last 1M | end-July | 1M | 3M |
| Reference rate | 0.25 | 0.00 | **4.75** | → | → |
| WIBOR 3M | 16 | -2 | **5.11** | → | → |
| 2Y bond yield | -47 | -41 | **4.20** | ↘ | → |
| 5Y bond yield | -47 | -30 | **4.41** | ↘ | → |
| 10Y bond yield | -55 | -29 | **4.85** | ↘ | → |
| 2/10Y curve slope | -8 | 12 | **65** | → | → |

*Note: Single arrow down/up indicates at least 5 bps expected move down/up, double arrow means at least 15 bps move*

| **Rates: our view and risk factors** | |
|---|---|
| **PLN rates market** | **Money market:** Intensification of interest rate cuts expectations resulted in significant decrease in FRA rates. Now market is pricing-in rate cuts by 100bps in 9M (FRA 9x12 at 4.13%). In coming weeks we expect range trading, but macroeconomic data could influence FRA rates in short-term. |
| | **Short end:** The short-end of the curve has continued downward move due to strong demand of foreign investors and strong hopes for interest rate cuts in Q4 2012. We are a bit more pessimistic in case of CPI inflation reading, expecting 4.3%YoY (higher than market consensus), which might bring front-end of the curve slightly up after recent rally, but sill below the level recorded at the end of July. |
| | **Long end:** Strong demand on mid and long end of the curve pushed yields down to a new low in this year. We foresee 5Y yield to be slightly lower (between 4.30-4.35%), while 10Y should anchor slightly below 4.80%. |
| | **Risk factors to our view:** Recent comments of MPC members indicate that the MPC might start discussing interest rate cuts on its September's meeting. If this materialises, the spread 2-10Y would widen. The risk for the long end is mostly connected with situation in peripheries of euro zone. |

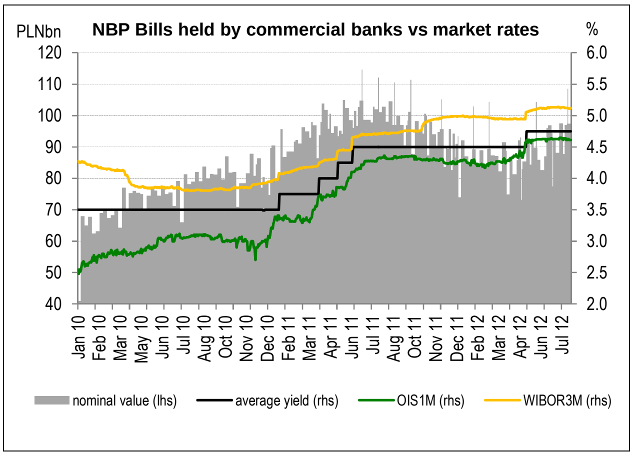
## FX market

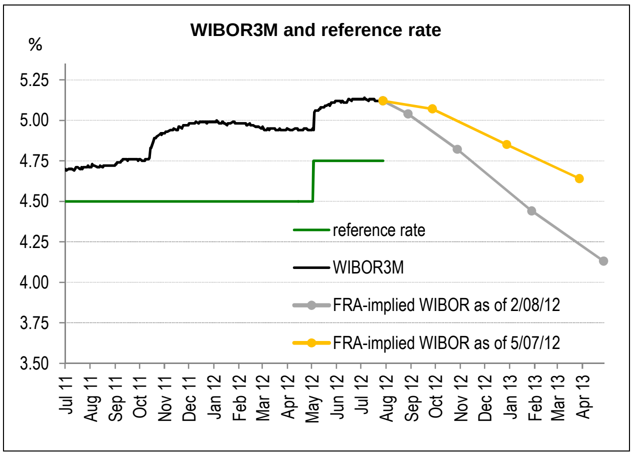
| | Change (%) | | Level | Expected trend | |
|---|---|---|---|---|---|
| | Last 3M | Last 1M | end-July | 1M | 3M |
| EURPLN | -1.5 | -3.6 | **4.11** | → | ↗ |
| USDPLN | 6.3 | -1.1 | **3.35** | ↗ | ↗ |
| CHFPLN | -1.8 | -3.6 | **3.42** | → | ↗ |
| GBPPLN | 2.6 | -0.6 | **5.26** | → | ↘ |
| EURUSD | -7.4 | -2.5 | **1.23** | → | → |

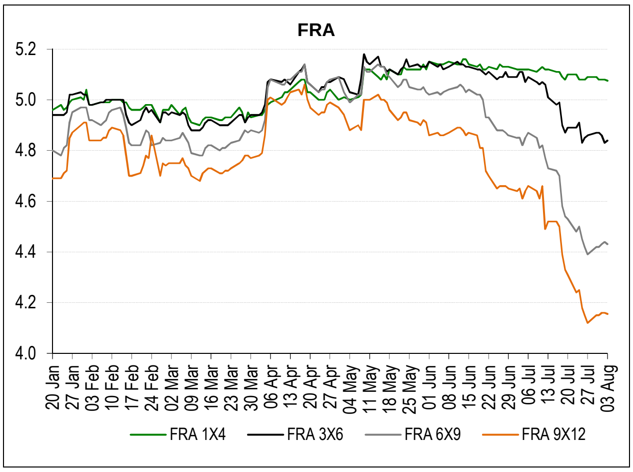
*Note: Single arrow down/up indicates at least 1.5% expected move down/up, double arrow means at least 5% move*

| **FX: our view and risk factors** | |
|---|---|
| **PLN FX market** | **EUR:** The end of July and the beginning of August were favourable for the zloty. The EURPLN has broken 4.05, a strong support level. We do not exclude the rate will test psychological support at 4.00 in coming days/weeks. If it is broken, the EURPLN will continue downward move towards the next support at 3.90. |
| | **USD:** We assume the EURUSD to stabilize slightly above 1.23 and thus any moderate movements in EURPLN would result in some moderate upward move of the USDPLN rate. |
| | **CHF:** We do not change our scenario, assuming the EURCHF around 1.20. |
| | **Risk factors to our view:** Wave of negative mood due to higher worries regarding euro zone's peripheries, especially in case of Spain and Italy, which can result in the US dollar appreciation. As a result the zloty could depreciate after strong rally. |

# Money Market




### OIS rates have discounted rate cuts by 100bps in 1 year …

- July was another month in a row of high cost of cash despite relatively high liquidity in the Polish banking sector. For the better part of the month Polonia rate stayed at elevated level, very close to the reference rate (spread oscillated near 5bps on average). Redemption of OK0712 and interest payments, which generated net inflows to the market of ca. PLN10bn caused sharp decline in Polonia rate to 4.06%. However, it was only short-lived move and in the following days the rate increased towards the refi rate, ending the month at 4.70%.
- As regards OIS market, rates have continued their downward trend. As in previous month the highest decrease was recorded in case of one-year rate (by 30bps in monthly terms). Currently OIS market is pricing-in interest rate cuts by 100bps, including two cuts in Q4 2012, which is in line with investors' expectations on FRA market (see below).
- In July we also observed further narrowing of basis swap (by 15bps on average in monthly terms). It came partly from higher demand for the Polish bonds due to significant intensification of interest rate cuts expectations.

### … similarly as FRA market

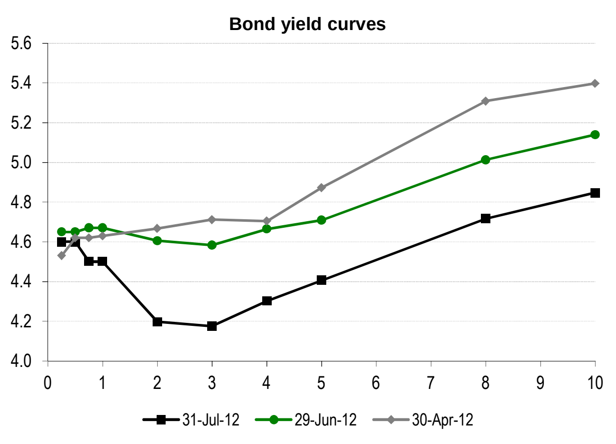
- FRA market in July was driven by bullish mood due to interest rate cuts expectations. Expectations for monetary policy easing as soon as in September intensified and this was supported by weak data (employment, industrial output, retail sales) and comments from the MPC members - not surprisingly Chojna-Duch and Bratkowski, but also Zielińska-Głębocka, who softened the tone of her statement. At the end of July market has priced-in a full 100bps cutting cycle within 12 months horizon, with the first cut in 3 months period.
- At the same time, WIBOR rates remained relatively stable in July. Rate of WIBOR 3M decreased slightly - only by 2bps to 5.11% in monthly terms, while FRA rates fell by 4-50bps (with the deepest decline in FRA6x9 and FRA9x12).
- Our base-case scenario still assumes official rates to remain stable till year-end because of the elevated inflation. In our opinion the MPC might start monetary easing cycle only at the beginning of 2013 as CPI inflation will return below the upper limit of NBP's inflation target i.e. 3.5% and economic activity will continue to slow down.
- FRA market may react to the upcoming macro data, mainly CPI inflation, industrial output and retail sales. We think that July's readings could bring some rebound, similarly as the unexpected rise in PMI index. Therefore, macro data, which will be released this month, might generate a temporary increase in FRA rates, although the scale of reaction to hawkish data may be limited, as was the case in July. Moreover, weak 2Q GDP reading at the end of August will probably revive calls for cut in September again.

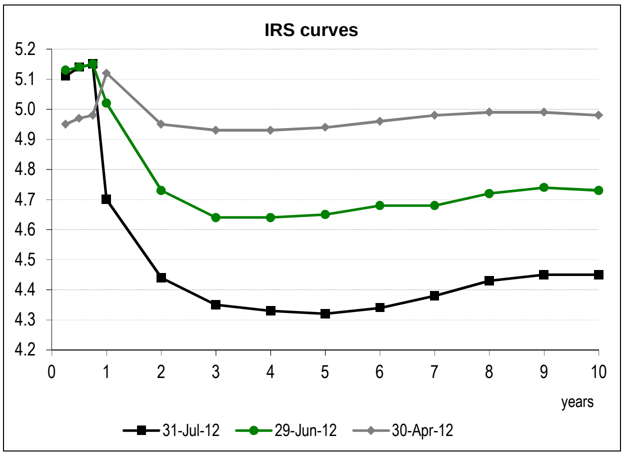
**Money market rates (%)**

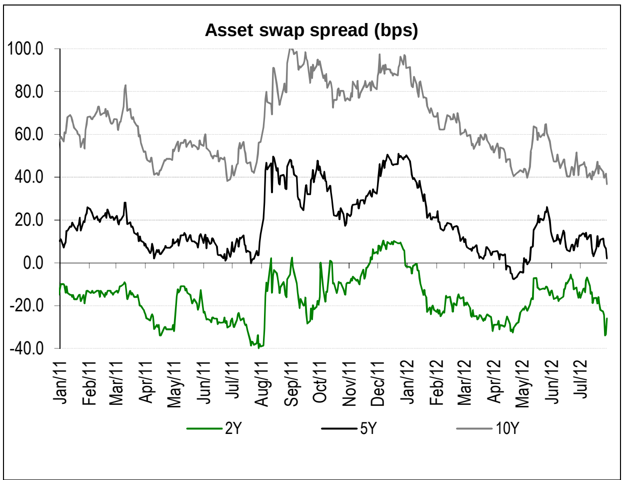
| | Reference | Polonia | WIBOR (%) | | | | OIS (%) | | | | FRA (% | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | rate (%) | (%) | 1M | 3M | 6M | 12M | 1M | 3M | 6M | 12M | 1x4 | 3x6 | 6x9 | 9x12 |
| **End of July** | **4.75** | **4.66** | **4.91** | **5.11** | **5.14** | **5.15** | **4.63** | **4.53** | **4.38** | **4.16** | **5.08** | **4.87** | **4.42** | **4.15** |
| **Last 1M change (bp)** | 0 | -12 | 0 | -2 | 0 | 0 | 0 | -10 | -20 | -31 | -5 | -22 | -44 | -50 |
| **Last 3M change (bp)** | 25 | 68 | 19 | 16 | 17 | 17 | 22 | 6 | -13 | -37 | 8 | -22 | -67 | -82 |
| **Last 1Y change (bp)** | 25 | 3 | 29 | 40 | 36 | 30 | 31 | 19 | 2 | -23 | 34 | 2 | -51 | -82 |

*Sources: Reuters, BZ WBK*

# IRS and T-Bond Market




### The short-end aggressively prices-in rate cuts

- Despite global mood deterioration due to rising fears about the euro zone peripheries (mainly situation in Spain) domestic bonds were doing relatively well, especially on the short-end of the curve. It came from intensification of interest rate cuts expectations after disappointing macro data (readings of employment, industrial output and retail sales were well below market predictions). The MPC members' statements (Chojna-Duch, Bratkowski, Zielińska-Głębocka) also supported the front end of the curve. Yield of 2Y benchmark declined sharply in July by slightly above 40bps in monthly terms to 4.20%, reaching the lowest level since April 2006. This trend was continued at the start of August.
- As regards the mid- and long-end of the curve, yields also declined in July, but the scope of changes was lower compared with 2Y sector and amounted to 27bps in both sectors. The 10Y sector was mainly affected by external factors, resulting from the increased volatility on the global financial market. Profit-taking after negative news flow from Spain sent yield of 10Y benchmark to above 5% for a while and then anchored below 4.80%. All in all, it created a bull steepener.
- As for IRS market, rates have followed moves on the bond market, but scope of changes was more or less similar in all sectors. However, more significant decrease in rates up to 5 years in the first part of July caused a yield curve flattening with 2-10Y spread at 1bp at the end of month (up from -19bps in mid-July). Asset swap spread in 10-year sector after significant narrowing to 40bps, rose temporarily to 50bps at the end of July.

### Correction might be short-lived only

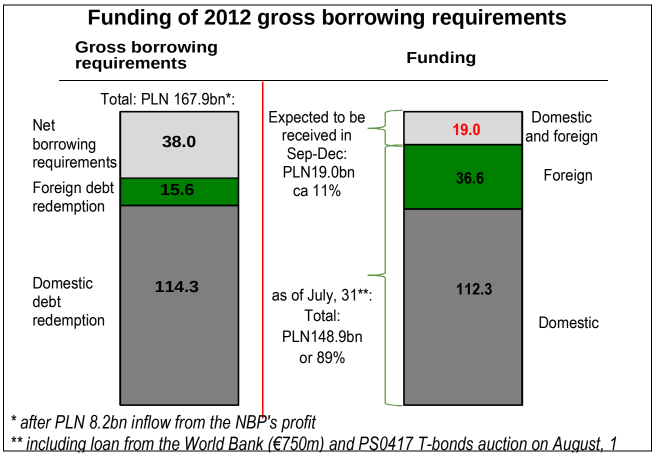
- The key factors, which influence the Polish bond market, have remained unchanged and valid. While the front-end and also the middle of the yield curve are supported by strong interest rate cuts expectations, the long of the curve might be under pressure if global moods deteriorate (due to situation in the euro zone peripheries). Very limited issuance plan for upcoming months supports bonds across the curve.
- Ahead of September's MPC meeting investors focus attention on macro data. We expect some rebound of July's figures, which might cause corrective move, especially on the short end. Intraday changes in yield of 2Y are relatively high, which might suggest that further decline is rather limited.
- In case of 5Y and 10Y sectors, we foresee range trading of yields in August. However, we observed strong relation between the Polish yields on mid and long end of the curve and Germany bonds of the same maturity. The higher yield of 10Y Bund, the higher probability of upward move of the Polish 10Y bond.

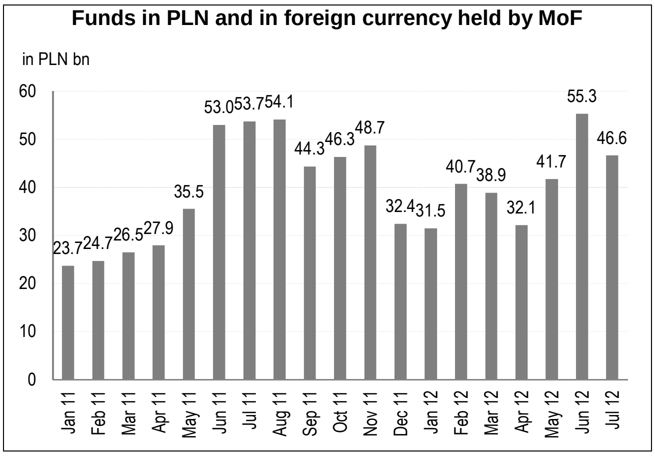
### Bond and IRS market (%)

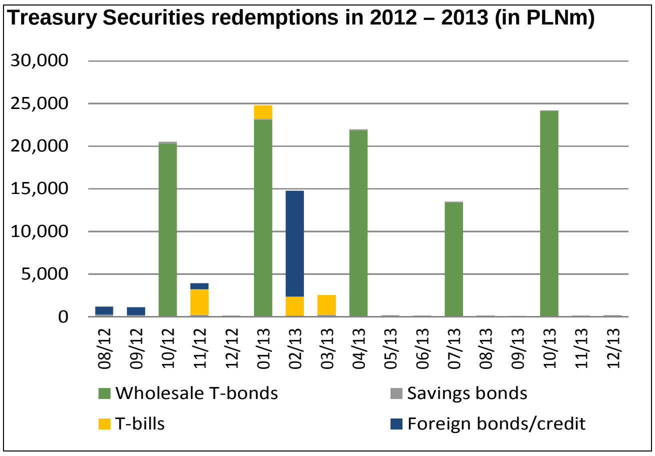
| | T-bills | BONDS | | | IRS | | | Spread BONDS / IRS (bp) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 52-week | 2Y | 5Y | 10Y | 2Y | 5Y | 10Y | 2Y | 5Y | 10Y |
| **End of July** | **4.50** | **4.20** | **4.41** | **4.85** | 4.44 | 4.32 | 4.45 | -24 | 9 | 40 |
| **Last 1M change (bp)** | -17 | -41 | -30 | -29 | -29 | -33 | -28 | -12 | 3 | -1 |
| **Last 3M change (bp)** | -13 | -47 | -47 | -55 | -51 | -62 | -53 | 4 | 15 | -2 |
| **Last 1Y change (bp)** | -13 | -44 | -87 | -94 | -58 | -94 | -92 | 14 | 7 | -2 |

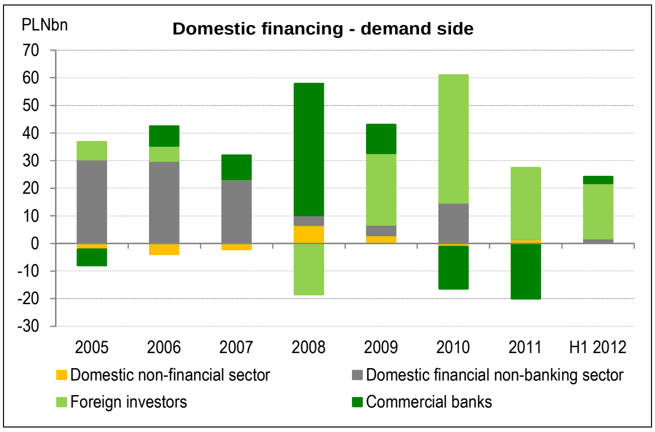
*Sources: Reuters, BZ WBK*

# Treasury Securities Supply Corner




*Sources: Ministry of Finance, BZ WBK*

### Cost of domestic funding lower and lower

- As predicted, the Ministry of Finance successfully conducted auctions on the domestic market in July. It sold PS0417 and DS1021 worth PLN4.9bn in total at switch tender and OK0714 worth PLN5.84bn at the standard and additional tenders. The latest auction attracted a healthy demand of PLN11.36bn (bid-cover ratio at 2.35), which resulted in auction yield decline to 4.361%, the lowest level since March 2006, but also well below the level on the secondary market.
- At the end of July the Ministry has already covered 84% of its 2012 borrowing requirements (up from 78% at the end of June). What is interesting the Ministry has kept its funds in PLN and in foreign currency above PLN45bn.

### The borrowing needs to be completed at the end of Q3

- Usually August is a quiet month in the primary market. This August is even exceptionally lightly loaded with tenders, as the Ministry of Finance offered only 5Y benchmark PS0417 on standard auction It attracted relatively strong demand (PLN7bn, with bid-cover ratio at 1.59). It came from both domestic and foreign investors. It is worth to remind that only part of funds from redemption (PS0712) and coupon payment were used on July's auction of OK0714. Thus, liquidity position was very supportive for auction.
- One should notice that investors bid aggressively on the auction and as a result auction yield fell to 4.361%, the lowest level in history of 5Y benchmark tenders. It was also well below the level on the secondary market and by 42bps lower than in May. Interestingly, the yield on 2Y auction in July was exactly the same as the yield of on 5Y auction in August.
- As regards foreign financing, at the beginning of August the World Bank will pay out the second tranche of the loan planned for this year, in the same amount as the first one, i.e. €750m.
- Taking into account above inflows, currently the 2012 borrowing needs are financed in ca. 90%. It ensures the Ministry's plan to fully conclude financing this year requirements by the end of Q3.

### Strong dependency on non-residents

- It is likely that the Ministry of Finance will start pre-financing 2013 borrowing needs through switch tenders (in September it is likely that the Ministry of Finance will buy back bonds maturing in January 2013) if market conditions are favourable. As a consequence, it means moderate issuance plan for Q4 2012.
- The value of bond redemptions in 2013, is by 20% lower compared with this year, so the situation is easier to manage and the pressure is not as significant as in the past. Nevertheless, the uncertainty regarding market conditions is very high, so the Ministry would probably like to start next year with some surplus on the account.
- Breakdown of debt financing is worth scrutinizing. In H1 2012, as in the same period of 2011, the borrowing needs have been financed mostly by foreign investors, who increased their involvement to the new record high. It creates a threat of outflows if global sentiment deteriorates significantly and in our opinion it is a main risk factor for the Polish assets in the medium term.
- Currently, in our opinion, this threat is relatively low. Record-low interest rates in the euro area encourage demand for higher returns in other markets, including Polish assets. Moreover, expectations for monetary easing by central banks also support investors' optimism. All these factors together with Poland's positive fundamentals against the background of the euro zone have anchored non-residents' demand.

# Treasury Securities Supply Corner

### Total issuance in 2012 by instruments (in PLNm, nominal terms)

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| T-bonds auction | 10,820 | 11,503 | 10,560 | 9,012 | 8,341 | 4,974 | 5,842 | 4,411 | 4,000 | 4,000 | 2,000 | 0 | 75,462 |
| T-bills auction | 2,223 | 5,778 | 3,000 | | | | | | | | | | 11,001 |
| Retail bonds | 216 | 248 | 212 | 210 | 210 | 210 | 150 | 156 | 160 | 150 | 150 | 150 | 2,221 |
| Foreign bonds/credits | 7,979 | 2,200 | 0 | 5,390 | 1,251 | 9,675 | | 3,075 | | | | | 29,569 |
| Prefinancing and financial resources at the end of 2011 | 31,600 | | | | | | | | | | | | 31,600 |
| **Total** | **52,837** | **19,729** | **13,772** | **14,611** | **9,802** | **14,859** | **5,992** | **7,642** | **4,160** | **4,150** | **2,150** | **150** | **149,854** |
| Redemption | 11,297 | 3,981 | 5,275 | 20,795 | 4,906 | 2,778 | 20,459 | 3,191 | 1,122 | 21,427 | 2,256 | 2,368 | 99,855 |
| **Net inflows** | **41,540** | **15,749** | **8,496** | **-6,183** | **4,896** | **12,080** | **-14,467** | **4,450** | **3,038** | **-17,277** | **-106** | **-2,218** | **49,998** |
| Rolling over T-bonds | 6,309 | | | 7,966 | | 2,459 | 4,908 | | | | | | **21,641** |
| Buy-back of T-bills | | | | | | | | | | | | | **0** |
| **Total** | **47,848** | **15,749** | **8,496** | **1,782** | **4,896** | **14,539** | **-9,559** | **4,450** | **3,038** | **-17,277** | **-106** | **-2,218** | **71,639** |
| *Coupon payments* | *1,451* | | | *7,211* | | | *1,497* | | *1,455* | *7,413* | | | *19,026* |

*Note: Our forecasts – shaded area*

### Schedule Treasury Securities redemption by instruments (in PLNm)

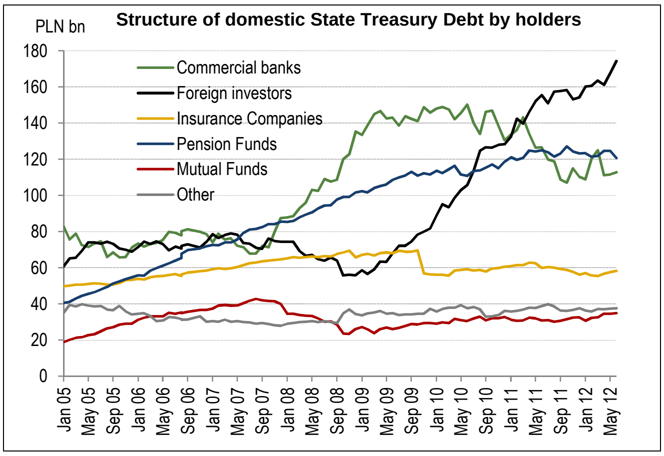
| | Bonds | Bills | Retail bonds | Total domestic redemption | Foreign Bonds/Credits | Total redemptions |
|---|---|---|---|---|---|---|
| January | 10 946 | 0 | 351 | **11 297** | | **11 297** |
| February | | 3 799 | 182 | **3 981** | | **3 981** |
| March | | 1 997 | 129 | **2 125** | 3 150 | **5 275** |
| April | 20 663 | | 132 | **20 795** | | **20 795** |
| May | | 2 223 | 117 | **2 339** | 2 567 | **4 906** |
| June | | | 112 | **112** | 2 666 | **2 778** |
| July | 14,341 | | 218 | **14,559** | 4,900 | **19,459** |
| August | | 1,997 | 248 | **2,245** | 946 | **3,191** |
| September | | | 176 | **176** | 946 | **1,122** |
| October | 20,262 | | 265 | **20,527** | | **20,527** |
| November | | 1,332 | 208 | **1,540** | 716 | **2,256** |
| December | | 2,223 | 146 | **2,368** | | **2,368** |
| **Total 2012** | 66,211 | 13,571 | 2,283 | **82,065** | 15,891 | **97,955** |
| Total 2013 | 82,468 | 6,110 | 1,698 | **90,276** | 14,825 | **105,102** |
| Total 2014 | 53,116 | 0 | 628 | **53,743** | 17,448 | **71,192** |
| Total 2015 | 78,880 | 0 | 485 | **79,365** | 14,329 | **93,694** |
| Total 2016 | 59,378 | 0 | 91 | **59,469** | 16,871 | **76,340** |
| Total 2017+ | 201,187 | 0 | 3,288 | **204,475** | 134,966 | **339,442** |

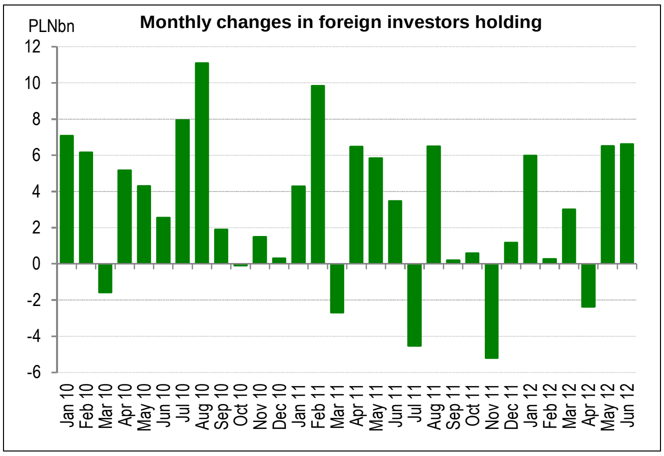
### Schedule wholesales bonds redemption by holders (data at the end of July 2012, in PLNm)

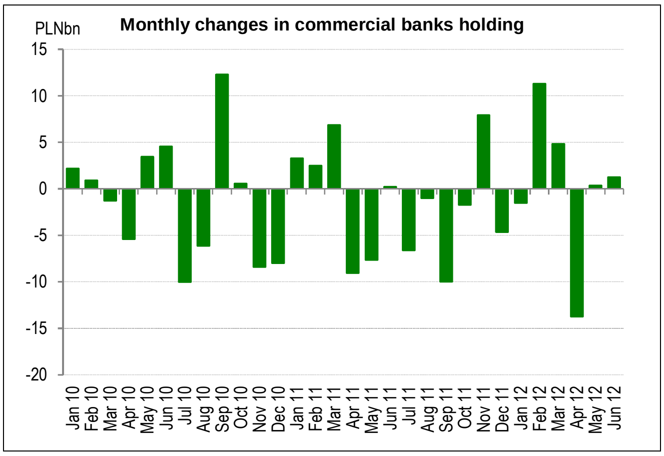
| | Foreign investors | Domestic banks | Insurance Funds | Pension Funds | Mutual Funds | Individuals | Non-financial sector | Other | Total |
|---|---|---|---|---|---|---|---|---|---|
| Q1 2012 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Q2 2012 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Q3 2012 | 7,837 | 6,045 | 1,731 | 1,828 | 727 | 121 | 36 | 1,403 | 19,729 |
| Q4 2012 | 10,566 | 5,000 | 1,132 | 2,585 | 1,143 | 80 | 30 | 2,085 | 22,620 |
| **Total 2012** | **18,402** | **11,045** | **2,864** | **4,413** | **1,870** | **201** | **66** | **3,488** | **42,350** |
| | **43%** | **26%** | **7%** | **10%** | **4%** | **0%** | **0%** | **8%** | **100%** |
| Total 2013 | 36,044 | 13,040 | 12,436 | 12,607 | 3,342 | 477 | 117 | 4,540 | 82,602 |
| | 44% | 16% | 15% | 15% | 4% | 1% | 0% | 5% | 100% |
| Total 2014 | 22,236 | 10,075 | 4,434 | 8,803 | 3,790 | 412 | 124 | 3,530 | 53,406 |
| | 42% | 19% | 8% | 16% | 7% | 1% | 0% | 7% | 100% |
| Total 2015 | 22,779 | 23,115 | 7,370 | 14,977 | 5,320 | 191 | 615 | 4,583 | 78,951 |
| | 29% | 29% | 9% | 19% | 7% | 0% | 1% | 6% | 100% |
| Total 2016 | 12,477 | 8,461 | 5,151 | 27,103 | 5,734 | 48 | 411 | 3,166 | 62,549 |
| | 20% | 14% | 8% | 43% | 9% | 0% | 1% | 5% | 100% |
| Total 2017+ | 55,503 | 36,694 | 24,041 | 55,821 | 12,965 | 272 | 812 | 8,482 | 194,591 |
| | 29% | 19% | 12% | 29% | 7% | 0% | 0% | 4% | 100% |

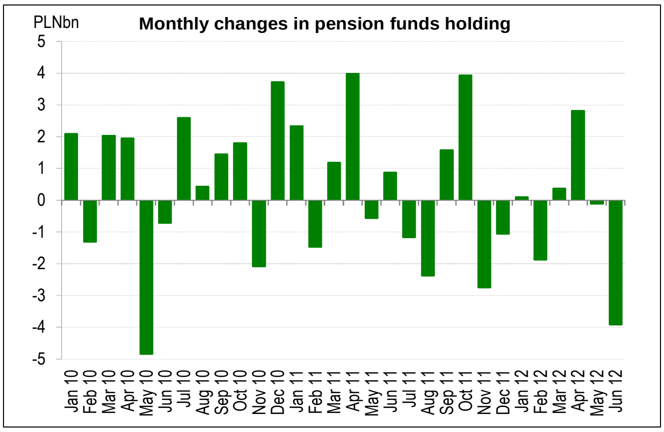
*Sources: Ministry of Finance, BZ WBK*

# Treasury Securities Holders




*Sources: Ministry of Finance, BZ WBK*

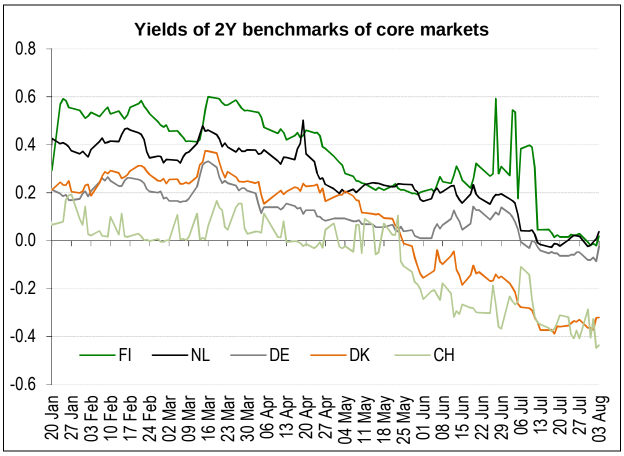
**Foreign investors portfolio hits a new record high (again)**

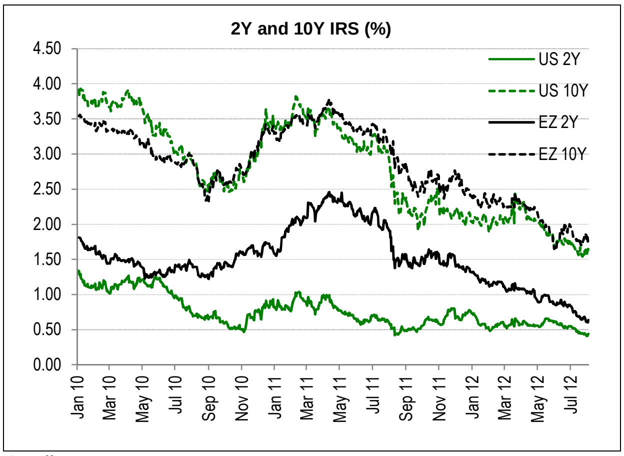
- Data from the Finance Ministry on marketable debt holders in June showed that foreign investors owned bonds and T-bills worth nearly PLN174.3bn, a new record after the highest (PLN6.6bn) monthly increase since Feb'11. Also their share in PLN denominated debt was at highest level in history, at 32.4% from 31.4% in May.
- In the first half of 2012 foreign investors purchased bonds worth PLN20bn and PLN10.7bn in Q2 alone. It is a quite considerable result when compared to purchased papers of nearly PLN26bn in 2011 as a whole.
- In June foreign investors increased their holdings of bonds with maturities up to 3-years to PLN100.7bn. There was also some visible inflow recorded in the mid-term bonds (PS0417 to PLN1.28bn from PLN0.24bn), but so far the share of these securities in total holding of foreign investors is rather insignificant (0.87% in case of mentioned bond).
- Foreign banks purchased bonds worth nearly PLN1.3bn after a reduction by PLN0.9bn observed in May. Biggest purchases were recorded in case of OK1012 (by PLN0.59bn) and PS1016 (by PLN0.76bn).
- Non-bank financial sector expanded its holdings of Polish bonds by PLN4.3bn to PLN143.1bn. Biggest purchases were carried in case of WS0922 (PLN0.88bn) and PS0417 (PLN0.91bn).
- Director of Public Debt Departament in the Finance Ministry, Piotr Marczak, said that in July the value of Polish debt held by foreign investors was reduced by PLN7.7bn due to maturity of OK0712.

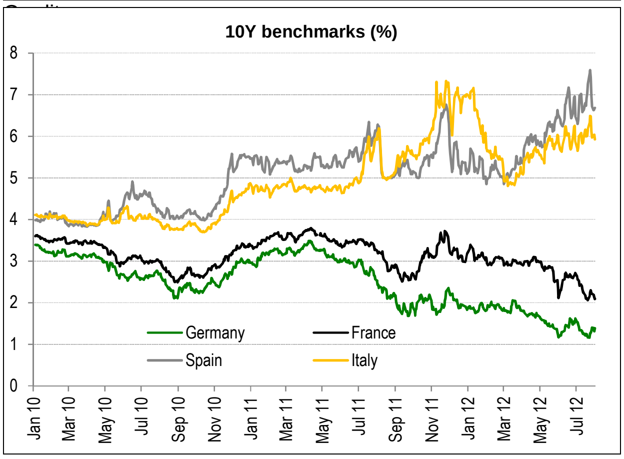
**Domestic investors on the supply side in June**

- Polish investors reduced slightly their portfolio of domestic bonds by ca. PLN1.3bn to nearly PLN353bn.
- The decline of value of bonds held by domestic investors was driven by visible reduction of securities held by pension funds. Interestingly, they clearly reduced their portfolio of domestic bonds, by PLN3.4bn. That was a first decline since Feb'12 and highest outflow since May '10. Nevertheless, this group maintained its position as second biggest holder of Polish bonds (22.8%).
- In first half of 2012 domestic investors cut its exposure to Polish bonds by PLN1.9bn compared to PLN1.1bn decline in H2'11 and PLN5.2bn increase in whole 2011.
- Domestic banks continued to cut their exposure to Polish bonds third month in a row but at clearly smaller scale (only PLN0.31bn reduction vs. PLN2.8bn in May) than in first two months of Q2. Currently they own securities worth PLN102.1bn, lowest since Jan'12. Their share in market bonds is at lowest level since October '11 (19.38%). Regarding the first half of 2012, holdings were reduced by PLN1.2bn (compared to cut by PLN1.6bn in H2'11 and PLN7.1bn reduction in whole past year).

# International Bond Markets




### The front-end of curve in negative territory

- Tension related to situation in Spain, worries about global economy outlook (after the IMF's cutting its GDP forecasts) resulted in strong demand for 'safe haven' bonds. Yield of 10Y Bunds fell to 1.126%, while yield of 10Y Treasuries to 1.381%, reaching a new record lows.
- One should notice that ECB's decisions at July's meeting to cut not only its key refinancing rate (to 0.75% from 1%), but also its overnight deposit rate (to zero from 0.25%) to historically low levels accelerated a rush into short-dated debt of core issuers. As a consequence yields on the front end of the yield curve of several core countries (e.g. Germany, Switzerland, Netherlands, Denmark and Finland) fell to negative territory.
- The end of July brought some profit-taking on Bunds and US Treasuries. It came from ECB governor's statement that "the ECB is ready to do whatever it takes to preserve the euro", which fuelled risk-on sentiment on the market. Improved mood affected safe haven assets and yields went higher by some 15-23bps on the mid and long end of the German curve and by 8-12bps in case of the US Treasuries.

### Yields of peripheries' bonds depend on ECB's wording

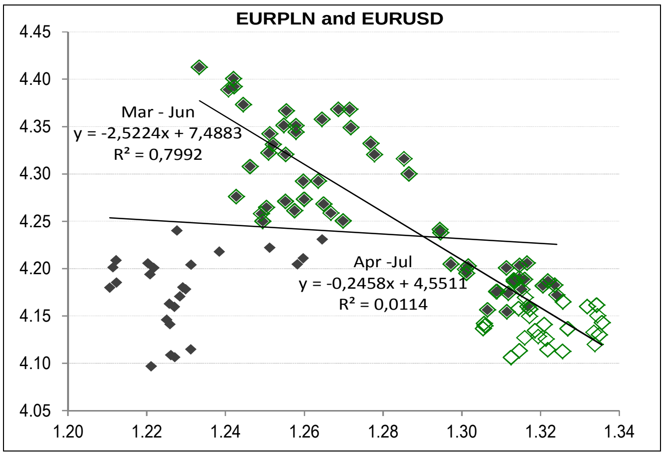
- The beginning of July was very stressful. The euro zone crisis has dominated the headlines due to escalating situation in Greece and (especially) in Spain, as investors' focus shifted to the funding situation in Spain. What is more, Moody's decided to downgrade credit rating not only for Italy, but also for its banks. All those factors together with fears of economic perspective after the IMF cut its global GDP forecast have resulted in a strong risk-off, with the 10Y Spanish bond trading near 7.75% and 10Y Italian bonds near 6.65%.
- The ECB governor Mario Draghi's statement has given a strong signal to the market that central bank policy would support the peripheries to bring funding costs down. It triggered a strong rally of Italy and Spain bonds, which yields fell significantly at the end of July (by more than 100bps in case of Spanish 10Y benchmark).
- However, the August ECB meeting failed to deliver the clarity, immediacy and decisiveness of action that some investors had hoped for. As a result yields of both Spanish and Italian bonds increased significantly, but stayed below the level observed before Draghi's wording.
- As usual, August is lack of significant issues of debt, also because some European countries have decided to cancel offers. It could give some breathe to the market. However, situation in euro zone peripheries (mainly Greece, Spain, Italy) is still uncertain and it is a main risk factors for global investors' mood.

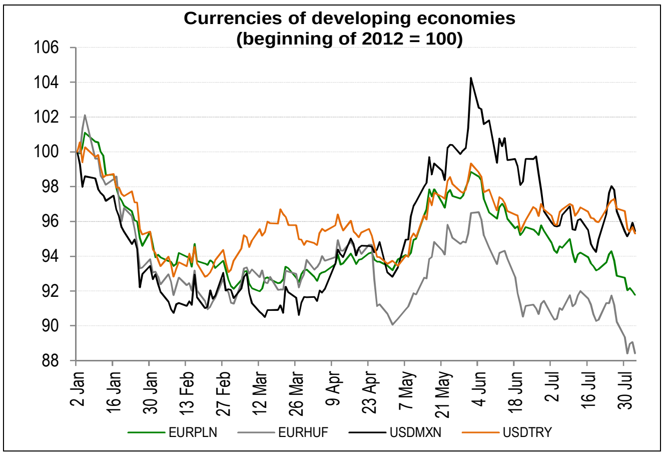
**Euro zone's issuance plans and completion in 2012 (€ bn)**

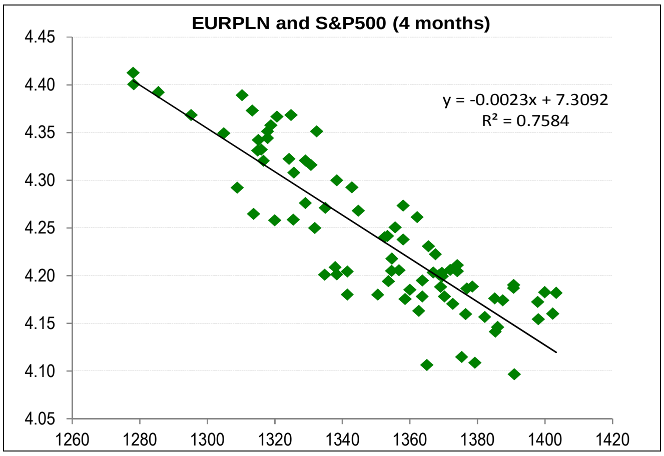
| | Total redemptions | Deficit | Borrowing needs | Expected bond supply | % of completion (YtD) |
|---|---|---|---|---|---|
| Austria | 14 | 8.3 | 22.3 | 22.3 | 83 |
| Belgium | 27.9 | 7 | 34.9 | 26.0 | 74 |
| Finland | 6.3 | 7.5 | 13.8 | 13.8 | 44 |
| France | 101.7 | 78.7 | 180.4 | 178 | 74 |
| Germany | 157 | 26.6 | 183.6 | 170 | 62 |
| Greece | 33.2 | 16.2 | 49.4 | - | - |
| Ireland | 5.5 | 13.7 | 19.2 | - | - |
| Italy | 192.2 | 41.1 | 233.3 | 233.3 | 54 |
| Netherlands | 29.7 | 12.3 | 42 | 60.0 | 85 |
| Portugal | 12.9 | 17.4 | 30.3 | - | - |
| Spain | 50.1 | 36.2 | 86.3 | 85.9 | 69 |
| **Total** | **630.5** | **265.0** | **895.5** | **789.2** | 65 |

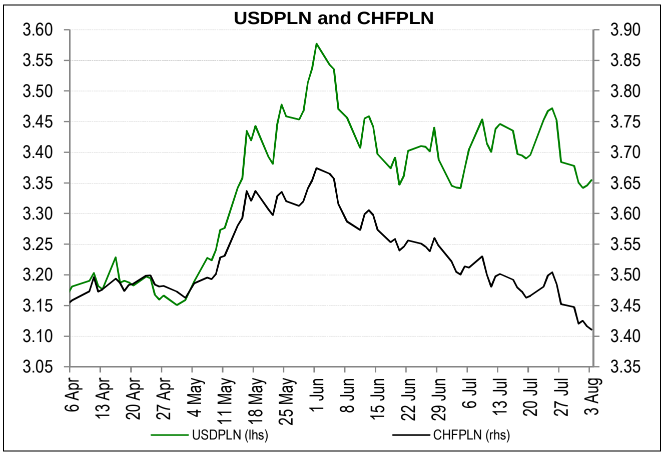
*Source: Reuters, BZ WBK*

# Foreign Exchange Market




*Sources: Reuters, BZ WBK*

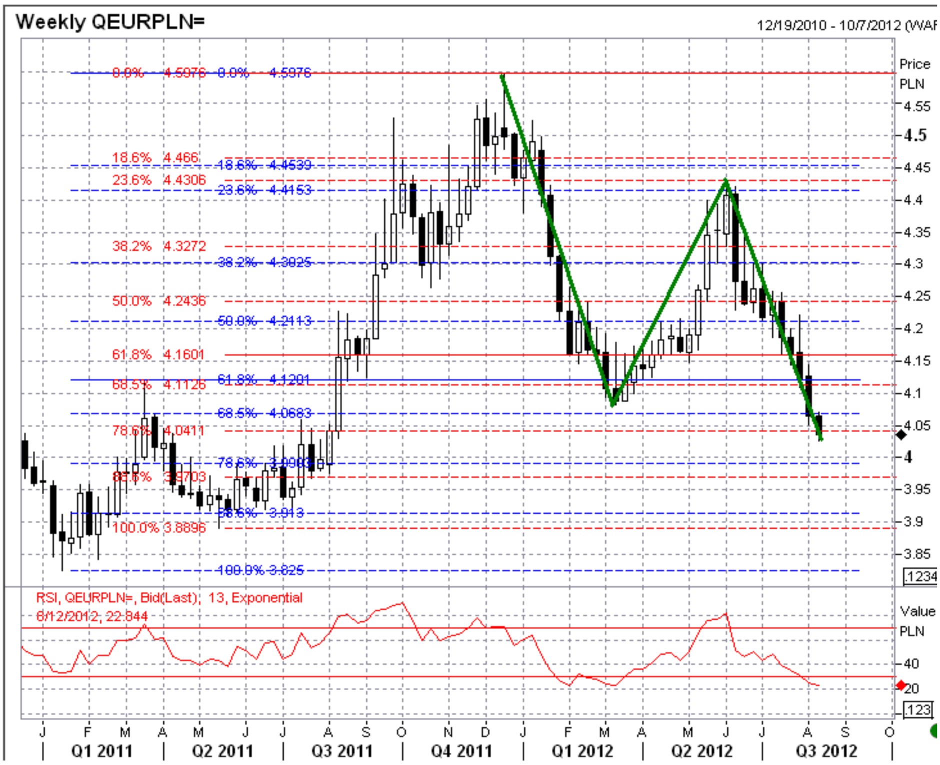
### Zloty resilient to worries over the euro zone

- In July the zloty gained versus the euro and Swiss franc and lost versus the dollar. The EURPLN and CHFPLN declined by 2.9%, while the USDPLN increased by 0.2% due to lower EURUSD.
- The average EURPLN trading range in July reached PLN0.16, below average for that month at PLN0.22 since 1999 mentioned by us in the previous report.
- The correlation with the EURUSD, which used to be one of the main drivers of the developments on the zloty's market in past months, proved irrelevant in July. The euro depreciated significantly versus the dollar due to soaring yields of Spanish and Italian bonds, but the Polish currency resisted the negative pressure from worries over the situation in the euro zone. Furthermore, the correlation of the EURPLN with other main instruments important from the debt crisis point of view also clearly plunged during the past month. For example four-months rolling correlation of daily changes of the zloty and the 10Y Spanish bonds yields fell from 0.8 to 0.2 and for Italian 10Y bond yields from 0.64 to 0.3. Only the relationships with the VIX and the S&P500 remained roughly unchanged and that suggests that in fact the zloty benefited mainly due to hopes for more action from central banks as that was one of factors providing fuel for stocks in July. The EURPLN continued the downward trend as the zloty was also supported by positive outcome of the EU summit and – more importantly – an ECB rate cut (including a deposit one to 0%).
- Since the beginning of August the domestic currency was still appreciating as the disappointing decision of the ECB (no clear announcement of nonstandard measures to be taken immediately on the peripheral bond market) was ignored and US better-than-expected payrolls data fuelled demand for risky assets. As a result, the EURPLN declined to nearly 4.03, the lowest level for a year.
- So far, the zloty has already gained nearly 10% against the euro this year and it is second best-performing currency (after forint that gained ca. 12%) among other emerging markets (RON, ZAR, TRY, RUB, BRL, MXN). The zloty is also second – again after the forint – strongest currency compared to levels seen at the beginning of Q2 and best performer since the beginning of Q3. It is worth to be aware that due to such visible appreciation, the domestic currency may be more prone to profit-taking than other currencies if risk aversion increases.

### The EURPLN may test 4.0

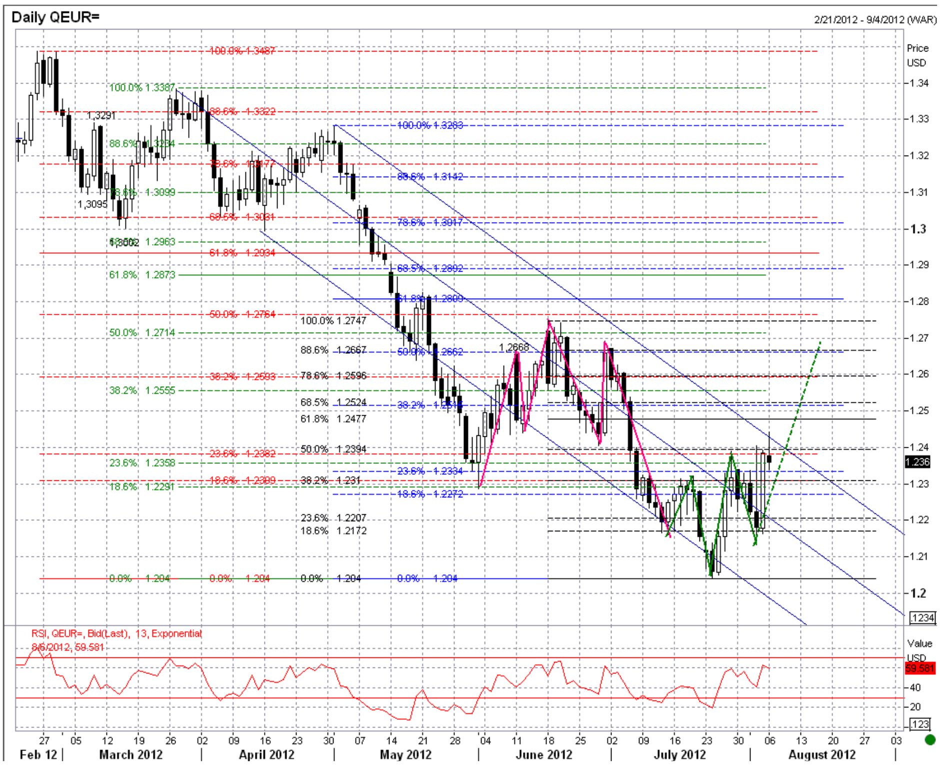
- It seems that behavior of the market seen after the decision of the ECB – that disappointed as no immediate actions will be taken in order to reduce yields on the euro zone peripheries – may be crucial in understanding situation on the FX market in the nearest future. During the press conference ECB's Draghi announced that in a few weeks' time measures aiming at lowering yields on the peripheral debt market will be presented. Despite lack of details on that measures, hopes for them to be finally taken may support market until next ECB meeting (on the September 6th) and prevent investors from betting for some another disappointment.
- So far the appreciation trend of the zloty is very strong and that tendency is also supported by further purchases of Polish bonds by foreign investors. We see these markets linked much more tight than in recent months and profit-taking on domestic FI market may have some negative impact on the zloty.
- In coming days the EURPLN may test support level at 4.0 if it stays below 4.05 for some time. Next support is at 3.90.

# FX Technical Analysis Corner




## EURPLN

- EURPLN broke support at ca. 4.20 and other supports below this level, so as a result the exchange rate declined just below 4.03 in early August, lowest for a year.
- There is a clear strong downward momentum on the EURPLN at the moment. The exchange rate is likely to decline further towards 4.0. At the current local low (4.026) the waves of pattern marked on the chart have quite decent Fibo ratios. That gives some chances for a stabilization of the exchange rate before it follows the downward trend.
- On weekly charts there is (for the time being) a divergence with the RSI and that may suggest that 4.0 will not be broken.




## EURUSD

- The suspicion of the H&S pattern to be painted on daily charts proved correct. EURUSD plunged even below projected 1.215.
- Currently the EURUSD is testing the cloud of Fibo resistance levels. If the exchange rate rises above the local peak at 1.244 then in following weeks it may head towards 1.27 if this time reversed H&S formation materializes.
- Factors that may constrain upward momentum is likely divergence with the RSI and the upper band of the downward trend.

*Sources: Reuters, BZ WBK*

# Poland vs other countries - economy

**Main macroeconomic indicators (European Commission's forecasts)**

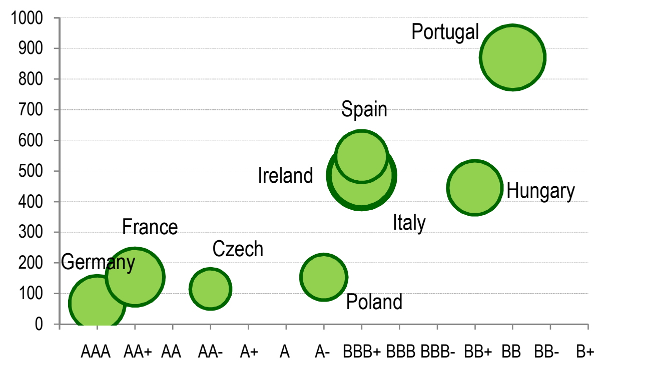
| | GDP* (%) | | Inflation* (HICP, %) | | C/A balance (% of GDP) | | Fiscal Balance (% of GDP) | | Public Debt (% of GDP) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2012F | 2013F | 2012F | 2013F | 2012F | 2013F | 2012F | 2013F | 2012F | 2013F |
| **Poland** | **2.7** | **2.6** | **3.7** | **2.9** | **-3.9** | **-4.2** | **-3.0** | **-2.5** | **57.1** | **57.5** |
| Czech Republic | 0.0 | 1.5 | 3.3 | 2.2 | -3.2 | -3.2 | -2.9 | -2.6 | 41.9 | 44.0 |
| Hungary | -0.3 | 1.0 | 5.5 | 3.9 | 2.2 | 3.7 | -2.5 | -2.9 | 76.5 | 76.7 |
| EU | 0.0 | 1.3 | 2.6 | 1.9 | 0.3 | 0.7 | -3.6 | -3.3 | 84.9 | 84.9 |
| Euro area | -0.3 | 1.0 | 2.4 | 1.8 | 0.6 | 1.0 | -3.2 | -2.9 | 90.4 | 90.9 |
| Germany | 0.7 | 1.7 | 2.3 | 1.8 | 4.7 | 4.5 | -0.9 | -0.7 | 82.2 | 80.7 |

*Note: * European commission – May 2012*

**Sovereign ratings**

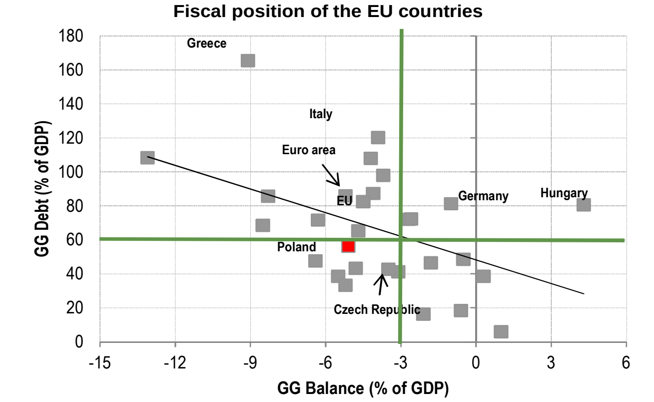
| | S&P | | Moody's | | Fitch | |
|---|---|---|---|---|---|---|
| | rating | outlook | rating | outlook | rating | outlook |
| Poland | A- | stable | A2 | stable | A- | stable |
| Czech | AA- | stable | A1 | stable | A+ | stable |
| Hungary | BB+ | negative | Ba1 | negative | BB+ | negative |
| Germany | AAA | stable | Aaa | negative | AAA | stable |
| France | AA+ | negative | Aaa | negative | AAA | negative |
| UK | AAA | stable | Aaa | negative | AAA | negative |
| Greece | CCC | stable | C | --- | CCC | stable |
| Ireland | BBB+ | negative | Ba1 | negative | BBB+ | negative |
| Italy | BBB+ | negative | Baa2 | negative | A- | negative |
| Portugal | BB | negative | Ba3 | negative | BB+ | negative |
| Spain | BBB+ | negative | Baa3 | negative | BBB | negative |

**5Y CDS rates vs credit ranking according to S&P**

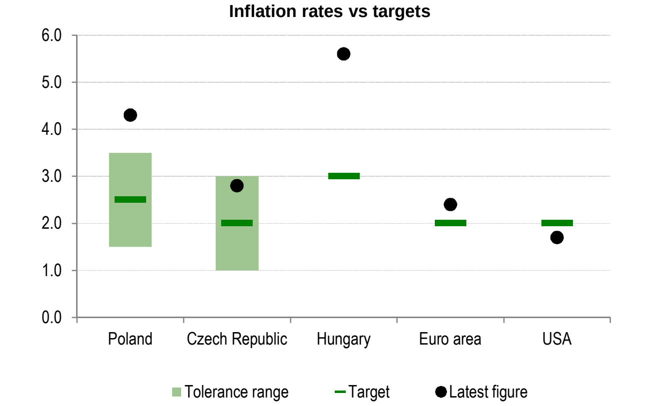



*Note: Size of bubbles reflects the debt/GDP ratio*

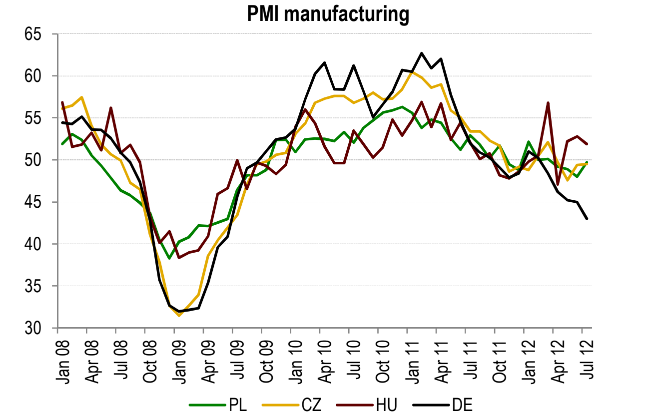
**Fiscal position of the EU countries**



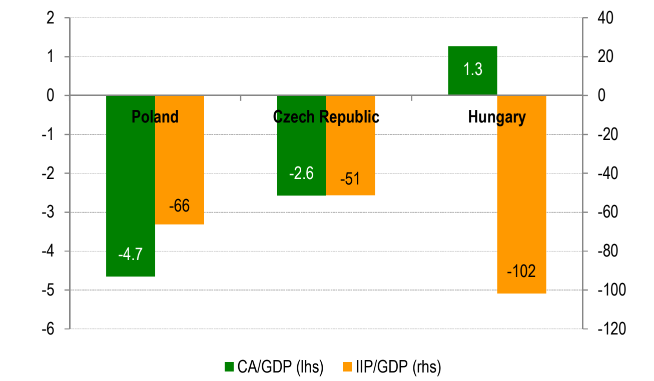

**Inflation rates vs targets**




**PMI manufacturing**




**Current account balance & International Investment Position (end of Q1 2012 - cumulative data, % of GDP)**

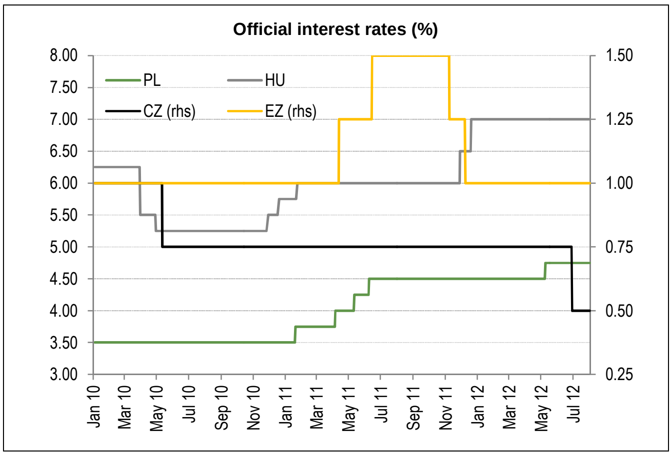


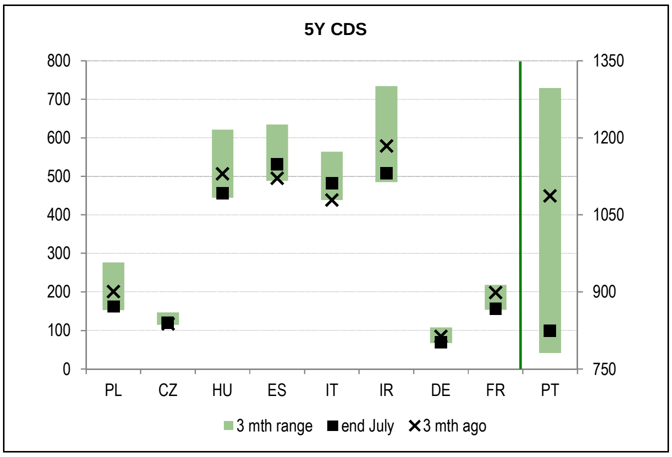

*Source: stat offices, central banks, Reuters. BZ WBK, EC*

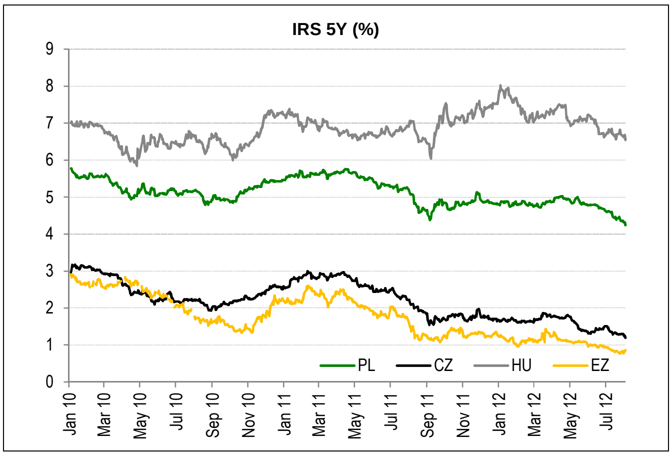
# Poland vs other countries - market

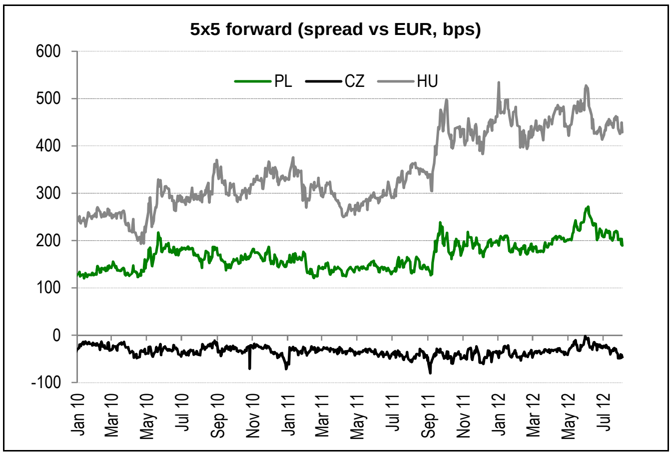
**Main market indicators (%)**

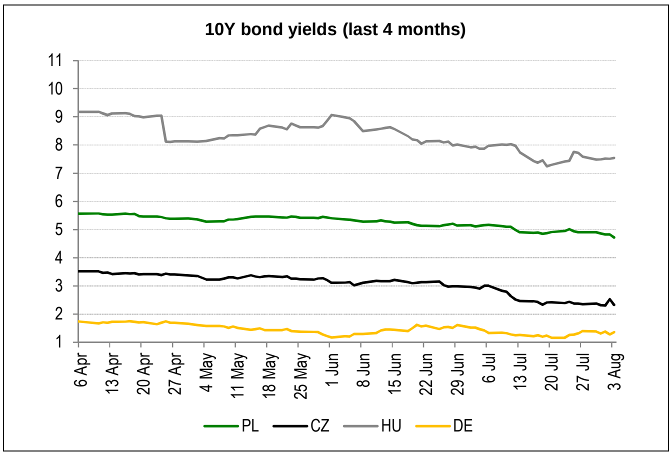
| | Reference rate (%) | | 3M market rate (%) | | 10Y yields (%) | | 10Y Spread vs Bund (bps) | | CDS 5Y | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2011 | 2012F | 2011 | end of July | 2011 | end of July | 2011 | end of July | 2011 | end of July |
| **Poland** | **4.50** | **4.75** | **4.99** | **5.11** | **5.88** | **4.86** | **405** | **355** | **279** | **169** |
| Czech Republic | 0.75 | 0.50 | 0.78 | 0.68 | 3.59 | 2.32 | 176 | 101 | 173 | 122 |
| Hungary | 7.00 | 7.00 | 7.24 | 7.18 | 9.90 | 7.49 | 807 | 618 | 610 | 458 |
| Euro area | 1.00 | 0.50 | 1.36 | 0.39 | | | | | | |
| Germany | | | | | 1.83 | 1.31 | | | 100 | 69 |

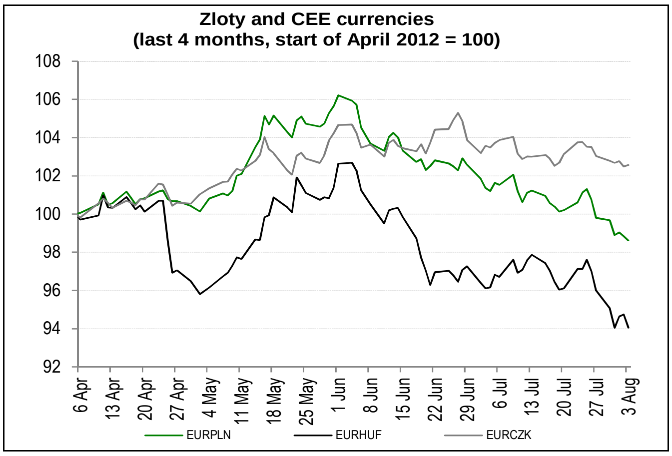



*Source: stat offices, central banks, Reuters. BZ WBK, EC*

# Central Bank Watch

| | | Last | 2011 | 2012F | Expected changes (bps) 1M | 3M | 6M | Risks |
|---|---|---|---|---|---|---|---|---|
| **Euro** | Forecast | 1.00 | 1.00 | 0.50 | | | | As expected, ECB kept interest rates unchanged, but signalled some complex moves to support peripheries. GDP data will be crucial for September's decision. |
| | Market implied » | | | | 0 | -8 | -11 | |
| **UK** | Forecast | 0.50 | 0.50 | 0.50 | | | | Rates on hold, but market does not exclude a further round of QE. |
| | Market implied » | | | | -10 | -18 | -22 | |
| **US** | Forecast | 0-0.25 | 0-0.25 | 0.25 | | | | Rates on hold. However, speculation of further stimulus is still valid. |
| | Market implied » | | | | 0 | -4 | -7 | |
| **Poland** | Forecast | 4.75 | 4.50 | 4.75 | | | | There is possibility that the MPC might vote a motion of interest rate cut in September. |
| | Market implied » | | | | -3 | -24 | -69 | |
| **Czech** | Forecast | 0.50 | 0.75 | 0.50 | | | | The CNB should keep interest rates unchanged in coming months, after trimming interest rates at its June's meeting to an all-time low. |
| | Market implied » | | | | 33 | 25 | 17 | |
| **Hungary** | Forecast | 7.00 | 7.00 | 7.00 | | | | The same story, possibility of deal between Hungary's government and IMF might allow the NBH to cut rates. |
| | Market implied » | | | | -12 | -37 | -72 | |

*Note: Market implied expectations show implied changes in 3M market rates based on FRA rates*

# Economic Calendar and Events

| Date | | Event: | Note: |
|---|---|---|---|
| 8-Aug | DE | Auction of 10Y bonds | Offer: €4.0bn |
| **14-Aug** | **PL** | **CPI for July** | **Our forecast: 4.3%YoY (above consensus) due to lower decline in food prices** |
| **17-Aug** | **PL** | **Employment and wages for July** | **We predict employment at 0.1%YoY and growth in wages by 3.8%YoY** |
| **20-Aug** | **PL** | **Industrial output for July** | **We expect temporary rebound to 5.4%YoY, above market consensus (3.9%YoY)** |
| **21-Aug** | **PL** | **Core inflation measures for July** | **We expect core inflation exc. food & energy prices at 2.4%YoY, above market expectations** |
| 22-Aug | DE | Auction of 2Y bonds | Offer: €5.0bn |
| ***27-Aug*** | ***PL*** | ***Retail sales for July*** | ***We are a bit more optimistic than market, expecting growth at 7.6%YoY vs 6.5%YoY*** |
| 28-Aug | HU | NBH Meeting – interest rate decision | Our forecast: 7.00% |
| | IT | Auction of long term bonds | - |
| **30-Aug** | **PL** | **GDP growth for Q2 2012** | **Our forecast at 2.6%YoY is below market expectations (2.9%)** |
| | IT | Auction of long term bonds | - |
| **5-Sep** | **PL** | **MPC Meeting – interest rate decision** | **We foresee interest rates to remain unchanged** |
| | DE | Auction of 10Y bonds | Offer: €5.0bn |
| 6-Sep | **PL** | **Switch tender** | **T-bonds to be repurchased may be securities maturing from October 2012 to January 2013** |
| | EZ | ECB Meeting – interest rate decision | - |

*Source: stat offices, central banks, Reuters, BZ WBK*

# Economic and market forecasts

| **Poland** | | **2010** | **2011** | **2012** | **2013** | **1Q12** | **2Q12** | **3Q12** | **4Q12** | **1Q13** | **2Q13** | **3Q13** | **4Q13** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| GDP | PLNbn | 1,416.4 | 1,524.7 | 1,618.7 | 1,691.0 | 370.5 | 391.8 | 399.4 | 453.3 | 389.9 | 409.3 | 417.7 | 474.0 |
| GDP | %YoY | 3.9 | 4.3 | 2.7 | 2.5 | 3.5 | 2.7 | 2.4 | 2.4 | 2.3 | 2.3 | 2.6 | 2.6 |
| Domestic demand | %YoY | 4.6 | 3.7 | 1.2 | 1.3 | 2.7 | 0.9 | 0.8 | 0.9 | 1.3 | 1.3 | 1.2 | 1.3 |
| Private consumption | %YoY | 3.2 | 3.1 | 1.9 | 2.3 | 2.1 | 1.7 | 1.8 | 2.0 | 2.0 | 2.2 | 2.4 | 2.6 |
| Fixed investments | %YoY | -0.2 | 8.3 | 4.9 | -1.8 | 6.7 | 6.5 | 5.0 | 3.0 | 1.0 | -1.0 | -4.0 | -2.0 |
| Unemployment rate [a] | % | 12.4 | 12.5 | 13.4 | 2.1 | 13.3 | 12.4 | 11.7 | 13.4 | 13.8 | 13.4 | 12.8 | 13.5 |
| Current account balance | EURm | -16,493 | -15,917 | -13,545 | -8,153 | -4,344 | -2,934 | -2,663 | -3,534 | -3,073 | -1,419 | -1,407 | -2,253 |
| Current account balance | % GDP | -4.7 | -4.3 | -3.5 | -2.0 | -4.7 | -4.6 | -4.0 | -3.5 | -3.1 | -2.7 | -2.4 | -2.0 |
| General government balance | % GDP | -7.8 | -5.1 | -3.0 | -3.0 | - | - | - | - | - | - | - | - |
| CPI | %YoY | 2.6 | 4.3 | 4.0 | 2.6 | 4.1 | 4.0 | 4.3 | 3.7 | 3.0 | 2.4 | 2.5 | 2.6 |
| CPI [a] | %YoY | 3.1 | 4.6 | 3.3 | 2.6 | 3.9 | 4.3 | 4.4 | 3.3 | 2.8 | 2.4 | 2.5 | 2.6 |
| CPI excluding food and energy prices | %YoY | 1.6 | 2.4 | 2.4 | 2.2 | 2.5 | 2.5 | 2.3 | 2.2 | 2.3 | 2.0 | 2.2 | 2.2 |
| EUR/PLN | PLN | 3.99 | 4.12 | 4.21 | 4.15 | 4.23 | 4.26 | 4.17 | 4.19 | 4.20 | 4.15 | 4.15 | 4.10 |
| USD/PLN | PLN | 3.02 | 2.96 | 3.34 | 3.38 | 3.23 | 3.32 | 3.40 | 3.43 | 3.47 | 3.39 | 3.36 | 3.29 |
| GBP/PLN | PLN | 4.66 | 4.75 | 5.19 | 5.01 | 5.07 | 5.26 | 5.27 | 5.17 | 5.22 | 5.06 | 4.91 | 4.85 |
| Reference rate [a] | % | 3.50 | 4.50 | 4.75 | 4.75 | 4.50 | 4.75 | 4.75 | 4.75 | 4.75 | 4.75 | 4.75 | 4.75 |
| WIBOR 3M | % | 3.94 | 4.54 | 5.07 | 5.05 | 4.97 | 5.04 | 5.12 | 5.14 | 5.08 | 5.02 | 5.02 | 5.07 |
| Yield on 52-week T-bills | % | 3.96 | 4.51 | 4.52 | 4.49 | 4.50 | 4.69 | 4.53 | 4.37 | 4.57 | 4.52 | 4.47 | 4.42 |
| Yield on 2-year T-bonds | % | 4.72 | 4.81 | 4.47 | 4.19 | 4.66 | 4.71 | 4.31 | 4.20 | 4.22 | 4.19 | 4.15 | 4.20 |
| Yield on 5-year T-bonds | % | 5.31 | 5.44 | 4.73 | 4.43 | 5.02 | 4.93 | 4.50 | 4.45 | 4.47 | 4.46 | 4.42 | 4.37 |
| Yield on 10-year T-bonds | % | 5.74 | 5.98 | 5.20 | 4.88 | 5.58 | 5.38 | 4.94 | 4.90 | 4.92 | 4.89 | 4.85 | 4.85 |

*Source: CSO, NBP, Finance Ministry, BZ WBK own estimates;* [a] at the end of period

This analysis is based on information available until 3rd August 2012 and has been prepared by:

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