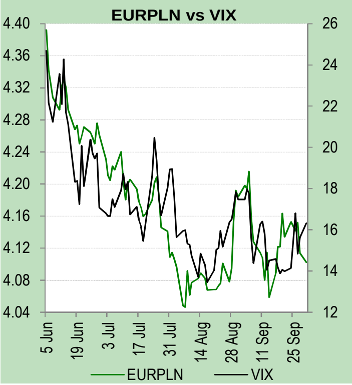
Bank Zachodni WBK

Rates and FX Outlook

Polish Financial Market

October 2012



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- **In the near future the key event for the market will be the MPC meeting.** Though in the last month's communique the Council did not suggest a rate cut, the majority of market participants expect the easing cycle to start in October. This is connected with a clear slowdown in the Polish economy, which is visible since the beginning of the year and has recently intensified. Data for August showed very low growth in industrial production and sales, while construction continues to show contraction. At the same time, the situation in the labour market remains unchanged (or even deteriorates further) with no real growth in wages and rising unemployment. This means that even if the current inflation rate is still elevated, the risk of second-round effect is limited. The slowdown ahead should bring the inflation rate down to the target in 2013. We still see the bottom of the economic cycle in 1Q13 with GDP growth of ca. 1%YoY. Actually, the demand-side pressure on prices is already limited with core inflation measures falling by one percentage point since the beginning of the year. Overall, the current and expected economic situation supports start of easing cycle (actually, supported already a few months ago). We believe there is majority within the Council that share that view. Nevertheless, the decision in October will be a close call and the view of one member may be crucial.
- **We still expect the official rates to be cut by 75 bp within the next few months with the first 25bp in October.** Our scenario of only short-lived correction after no rate cut in September materialised, as weak macro data contributed to aggressive pricing-in of monetary easing (by 100bps or more in 9 months period). We foresee downward trend of market rates to continue in coming weeks. The FRA market will probably overshoot the cycle of easing and this will also support the short-end of bonds and IRS curve. As a consequence we expect 2-10Y spread to continue to widen modestly in coming weeks. In the risk-case scenario of unchanged official rates in October, we think the market correction should prove to be short-lived, as the upcoming monthly data releases for September will be even worse than August's figures. For example, our forecast of industrial output (fall by ca. 7%YoY is one of the lowest on the market with consensus at -4%).
- **The zloty exchange rate has consolidated between 4.05-4.20 against the euro.** It seems that we have a combination of local and global forces working in the opposite directions. On the one hand, scenario of lower rates and weaker growth should weaken the currency. But on the other hand, actions by global central banks together with higher appetite for risky assets support emerging markets. In the following months we see asymmetric risk towards weaker zloty, as the role of local factors should intensify, while globally we can see some negative surprises on the euro area front. We see the average level of EURPLN at 4.15 in October.

This report is based on information available until 1st October

Short- and Medium-term Strategy

Interest rate market

	Change (bps)		Level	Expected trend	
	Last 3M	Last 1M	end-Sep	1M	3M
Reference rate	0	0	**4.75**	↘↘	↘↘
WIBOR 3M	-21	-7	**4.92**	↘	↘↘
2Y bond yield	-58	-4	**4.03**	↘	↘
5Y bond yield	-52	-16	**4.19**	→	↘
10Y bond yield	-45	-17	**4.69**	→	→
2/10Y curve slope	12	-13	**66**	↗	↗

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:** Our scenario of only short-lived correction after no rate cut in September materialised, as weak macro data contributed led to aggressive pricing-in of monetary easing (by 100bps or more in 9 months period). We foresee downward trend of market rates to continue in coming weeks, but we do not exclude a short-lived profit taking after the MPC's decision.
	Short end: The short-end of curve (both bonds and IRS) might benefit from intensification of interest rate cuts expectations. Market should continue to favour short-term instruments. As a consequence we foresee 2-10Y spread to continue to widen modestly in coming weeks.
	Long end: The medium and long term instruments are more dependent on global factors with quite strong correlation between Polish bonds and Bunds in 10Y sector. Potential for strengthening of 10Y bonds might be limited in the scenario of upward trend in Bunds' yields.
	Risk factors to our view: If the MPC postpones rate cut again (to see new GDP and CPI projection in November), we would see a profit-taking. However, it should be short-lived again, as investors are more concerned about the scale of the expected monetary easing than the date of its launch, especially given that next round of monthly data will be even weaker than in previous month.

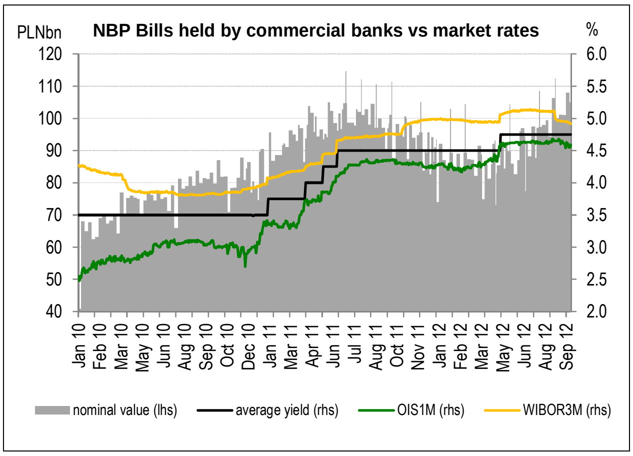
FX market

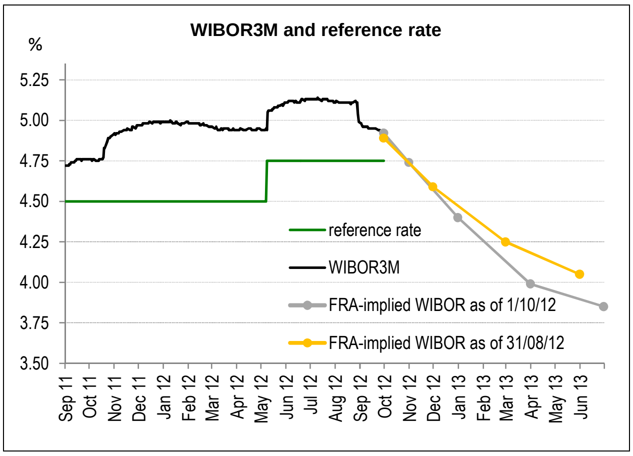
	Change (%)		Level	Expected trend	
	Last 3M	Last 1M	end-Sep	1M	3M
EURPLN	-3.5	-1.7	**4.11**	→	↗
USDPLN	-6.2	-4.7	**3.18**	↗	↗
CHFPLN	-4.1	-2.4	**3.40**	→	↗
GBPPLN	-2.5	-2.2	**5.16**	→	→
EURUSD	2.9	3.2	**1.29**	→	→

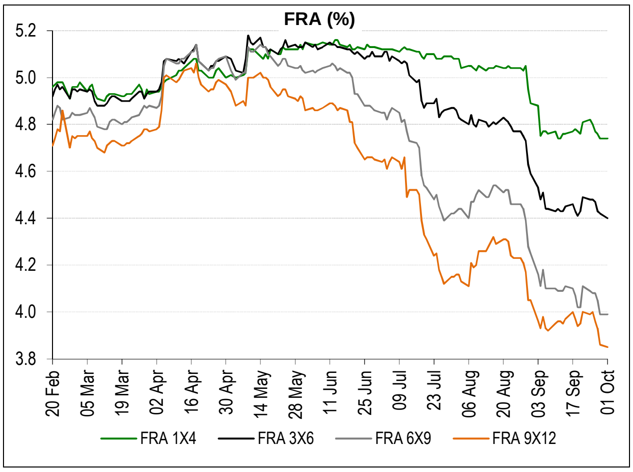
Note: Single arrow down/up indicates at least 1.5% expected move down/up, double arrow means at least 5% move

FX: our view and risk factors	
PLN FX market	**EUR:** The zloty has consolidated between 4.05-4.20 against the euro, awaiting the start of monetary easing. We see asymmetric risk towards weaker zloty amid rate cuts and weak data suggesting GDP below 2% in Q3. Additionally, global factors might be unfavourable as well. We see the average level at 4.15 in October.
	USD: The EMU debate, mainly related to Spain and Greece, will continue to be the main driver of EURUSD in the coming weeks. As a consequence we foresee the rate to stabilize between 1.28-1.30. Consequently, we expect the USDPLN to increase gradually towards 3.26 till year-end.
	CHF: Our scenario, assuming the EURCHF around 1.20 is still valid. We predict the CHFPLN to remain relatively stable in coming weeks, but in medium term the trend continues to be upward.
	Risk factors to our view: Greece and particularly Spain have been the source of increasing nervousness on financial markets. Prolonged period of lack of Spanish request for financial aid might negatively affect global investors' mood and result in emerging currencies depreciation.

Money Market







OIS rates show that rate cut in October is very likely…

- Liquidity situation in banking sector did not change significantly. Consequently, September's reserve period ended with a decent cash surplus. It suggests that cost of carry should soften a bit at the beginning of a new reserve period. One should notice that at the end of Q3 domestic commercial banks held nearly PLN100bn in NBP's bills.
- OIS rates, after some increase in the first part of September, continued to decline, with some significant fall at the end of month. In monthly terms OIS curve went down by 8-15bps, with decrease by more than 10bps in case of 1M and 9M rates.
- 9M OIS rate is oscillating near strong support at 4.0% and we do not exclude that level to be broken in if the MPC starts its monetary easing. Currently, OIS market is pricing-in rate cuts by 100bps in 9 months period, with the first cut this month.

…but scale of expected monetary easing is more crucial

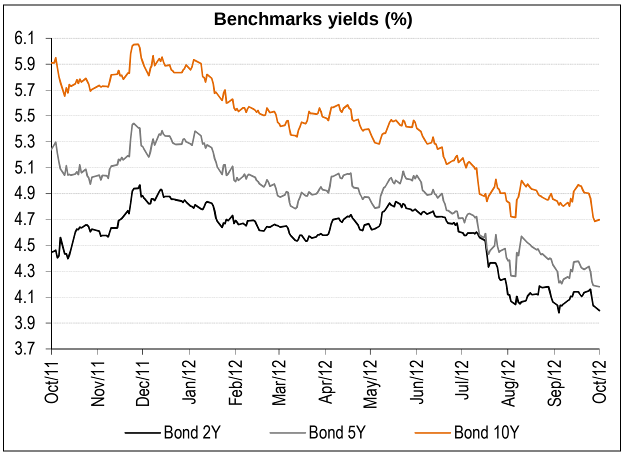
- WIBOR rates have continued their gradual decline. In September WIBOR curve declined by 0-7bps; while 1M rate remained unchanged, rates with maturity 3M+ gradually fell. At the end of Q3 WIBOR 3M was at 4.92%, a bit lower than we expected. One should notice that longer WIBOR rates (9M and 1Y at 4.95%, each) reached the lowest level since mid-November.
- The MPC's decision to keep interest rates unchanged in September caused FRA rates to increase. However, upward move proved to be only short-lived. Next weeks brought gradual decline after weak data releases and the move reinforced at the end of September fuelled by words of the NBP's Governor Marek Belka, who clearly announced monetary easing cycle. In monthly terms FRA rates declined by 15-26bps, with the highest scope of change in case of 6x9. Still, lows established after disappointing GDP data for Q2 in late August were not reached.
- One should notice that 3M FRAs are more than 50bps below current 3M WIBOR levels, indicating a high probability of rate cuts before year end. Currently FRA market is aggressively pricing-in monetary easing by 100bps (even a bit more) in 9 months' horizon. We maintain our view that the MPC is more cautious and less dovish that the market thinks, assuming that the Council will cut rates by 75bps in total during the cycle. In the meantime, however, market will overshoot event more.
- We expect the MPC to start monetary easing cycle in October and to give a hint on possible further cuts – just like NBP Governor suggested – and thus although FRA market prices-in rate cuts very aggressively we see some room for a further decline of these rates, at least in the short-term. We would like to highlight that investors are more concerned about the scale of the expected monetary easing than the date of its launch.

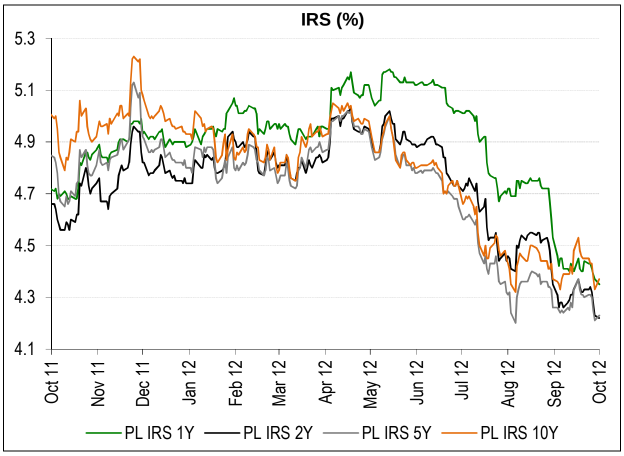
Money market rates (%)

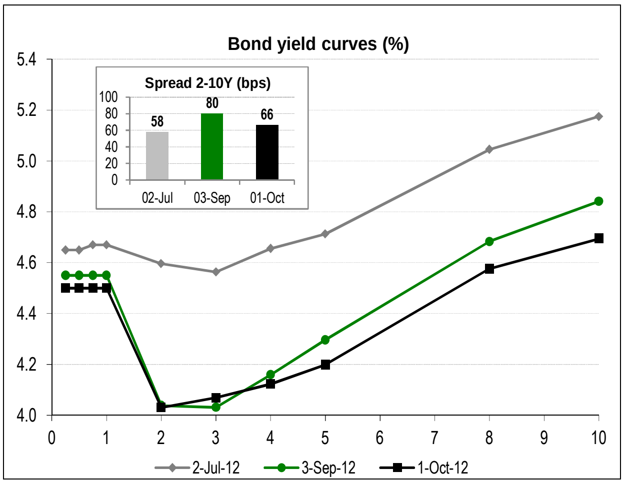
	Reference	Polonia	WIBOR (%)				OIS (%)				FRA (%)			
	rate (%)	(%)	1M	3M	6M	12M	1M	3M	6M	12M	1x4	3x6	6x9	9x12
End of September	**4.75**	**4.92**	**4.90**	**4.92**	**4.94**	**4.95**	**4.55**	**4.38**	**4.15**	**3.96**	**4.74**	**4.42**	**3.99**	**3.86**
Last 1M change (bp)	0	-1	-1	-19	-18	-17	-10	-17	-32	-27	-29	-33	-45	-35
Last 3M change (bp)	0	17	-1	-21	-20	-20	-9	-25	-46	-53	-39	-69	-88	-80
Last 1Y change (bp)	25	165	27	16	8	6	20	4	-16	-25	0	-29	-60	-63

Sources: Reuters, BZ WBK

IRS and T-Bond Market







10Y bonds outperform other assets…

- The September's MPC decisions disappointed market players (in spite of easing of the tone of communiqué). Decline on the front-end of both the IRS and bond curves proved to be short-lived and after the Council decision, rates have started rising gradually, towards 4.15% in case of 2Y bonds and 4.40% in case of 2Y IRS. Intensification of interest rate cut expectations (fuelled by words of NBP governor) helped the market to rebound in the last week of September, with yield of 2Y bond decline to near 4%.
- Yield of 5Y and 10Y bonds edged up in reaction to German yields drifting up, but spreads to Bunds narrowed significantly. Levels of 4.40% for 5Y and near 5.0% for 10Y acted as strong resistances and effectively stopped upward move. Together with some rebounds of Bunds, 5Y and 10Y benchmarks have gained very quickly (especially in the last week of September), trimming earlier losses. Additionally, the end-of-quarter effect also provided some support for Polish debt by investment funds. Consequently, yield of 10Y bond declined to lowest level since Q1 2006 (to 4.69%) and 5Y yield reached 4.17% (lowest in history).
- During September the strategy on bond market shifted from bear steepener to bull flattener. 2-10Y spread narrowed to 66bps, down from 85bps in mid-September and from 79bps at the end of August. In case of IRS 2-10Y spread, after some widening towards 15bps, has started to narrow and is currently oscillating around 10bps.

… but starting monetary easing will support the front end

- The MPC decision on interest rates will remain in the spotlight in October. We and market participants expect the Council to open the easing cycle by trimming official rates by 25bps. We uphold our view that the reference rate will decline to 4.25% till year-end, renewing strategy of bull steepener in medium term. The 2-10Y spread typically rises when the NBP engages in a cycle of monetary expansion.
- We remain positive on rates on the front end and mid of the curve not only due to rate cut, but also due to expected weak set of macro data, which will be published later this month. We foresee yield of 2Y, after some correction, to decrease towards 3.90% in a few months period.
- Yields of mid- and long-term bonds, in particular, will strongly depend on Bunds. Uncertainty about situation in peripherals (mainly in Spain) might shift demand on safe-haven assets, supporting also Polish bonds. Otherwise, potential for strengthening of 10Y bonds might be limited. Notwithstanding, low supply on the long end remains supportive for this sector. We foresee yield of 5Y to stay between 4.15-4.35%, while yield of 10Y between 4.65-4.85%.

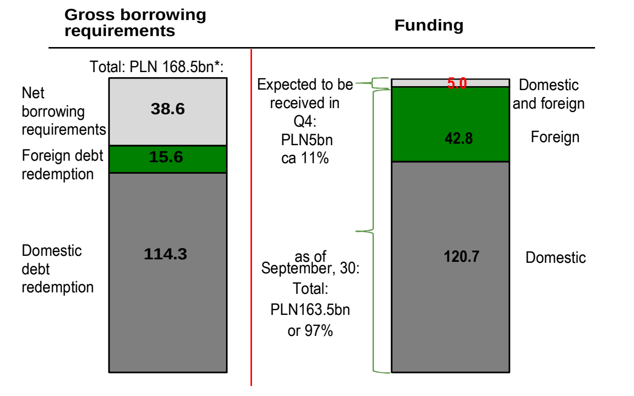
Bond and IRS market (%)

	T-bills	BONDS			IRS			Spread BONDS / IRS (bp)		
	52-week	2Y	5Y	10Y	2Y	5Y	10Y	2Y	5Y	10Y
End of September	**4.50**	**4.03**	**4.19**	**4.69**	**4.23**	**4.21**	**4.33**	**-20**	**-2**	**36**
Last 1M change (bp)	-10	-15	-21	-17	-28	-13	-8	13	-8	-9
Last 3M change (bp)	-17	-65	-58	-51	-52	-47	-42	-13	-11	-9
Last 1Y change (bp)	0	-42	-106	-128	-49	-72	-79	7	-34	-49

Sources: Reuters, BZ WBK

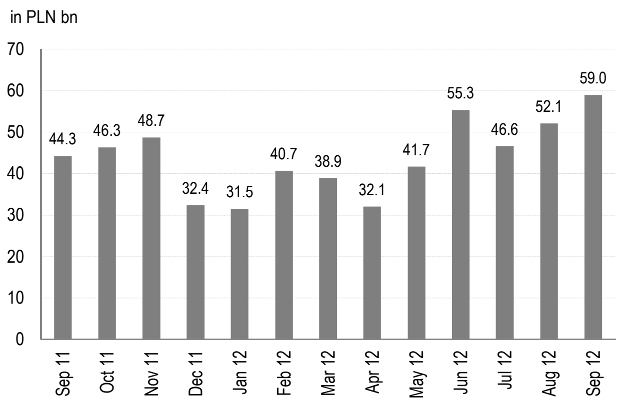
Treasury Securities Supply Corner

Funding of 2012 gross borrowing requirements



** expected execution acc. to assumptions set in the draft Budget Act for 2013*

Funds in PLN and in foreign currency held by MoF



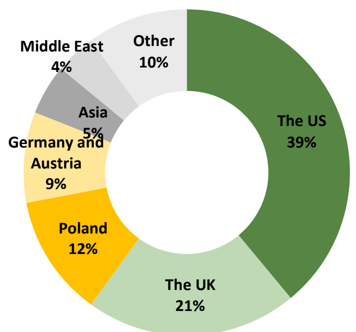
Bond auctions scheduled for Q4			
Regular tenders			
Auction date	**Settlement date**	**Series**	**Planned offer (PLN m)**
4 Oct 2012	8 Oct 2012	WZ0117 / PS0417 / WZ0121	3,000 – 5,000
23 Oct 2012	25 Oct 2012	OK0714 / DS1023	5,000 – 9,000
8 Nov 2012	12 Nov 2012	PS / DS / WS / WZ / IZ*	2,000 – 4,000
12 Dec 2012	*14 Dec 2012*	*Conditional auction - depending on market situation*	
Switch tenders			
21 Nov 2012	23 Nov 2012	PS / DS / WS / WZ / IZ**	-
6 Dec 2012	10 Dec 2012	*Conditional auction - depending on market situation*	

* *choice depending on the market situation*

** *choice depending on the market situation and the offer structure on the T-bond sale auction*

- T-bonds to be repurchased may be securities maturing from January to April/July 2013.

Geographical distribution of 10Y bonds denominated in the US dollar issued in September 2012



Sources: Ministry of Finance, BZ WBK

This year's borrowing needs are nearly covered

- According to our estimation at the end of Q3 the Ministry has already financed 97% of the 2012 borrowing needs and will complete this year's financing in October (it needs only PLN5bn from domestic debt sale).
- The Ministry successfully started pre-financing of next year's borrowing requirements, by selling nearly PLN2bn through switching auction and US$2bn on the foreign market. The Ministry hopes to pre-finance over 20% of next year's borrowing needs defined at PLN145bn in a draft of the 2013 budget low. However, the final scale of sales will depend on the situation on both the local and foreign financial markets.
- Poland increased its liquidity cushion denominated in PLN and FX to around PLN59bn at the end of September (up from PLN52.1bn at the end of August). A part of these means will be used for redemption and payment of interest on PLN Treasury bonds, which come to PLN25.7bn in October.

Liquidity situation supports high T-bonds offer in October

- The Ministry of Finance will come to the market to sell wholesale bonds worth PLN10-18bn in October-December period (up from PLN13.8bn in Q3) on three regular auctions. The Ministry also plans one or two switch tenders in Q4 (November and conditional in December); it refrained from holding switching auctions in October as "standard auctions are more effective under present conditions".
- In October, liquidity will be at a high level, with PLN16.4bn in redemptions of OK1012 and PLN9.3bn in coupon payments. Favourable liquidity situation is explaining the high offer of T-bond in October compared with next months in Q4 (near 80% of total supply or PLN8.0-14.0bn).
- As usual the Ministry approaches to T-bonds' supply flexibly in Q4, with the final offer depending on market conditions and the reported demand. The Q4 supply concentrates on the front end and the middle of the curve. Investors will be able to purchase 2Y benchmark OK0714 (as in July the Ministry decided to roll-over maturing debt into 2Y bonds).
- As expected, the MF decides to tap the market with a new 10Y benchmark issue. The Ministry will offer DS1023 in October together with 2Y benchmark.

The MF stayed active on the foreign market

- In September the Polish government launched a new 10Y benchmark denominated in the US dollar worth USD2bn, with demand reaching the level of USD8bn. The bond, maturing on 17 March 2023, was priced 150bps over yield of 10Y UST and 135bps over the interpolated mid-swap rate, which meant yield of 3.175%. One should notice that costs of Polish debt issue on the foreign markets declined significantly compared with the beginning of this year. It clearly shows how investors are mind-set about performance of Polish assets.
- The MF wants to tap foreign market with bond issue in Q4 2012. However, market selection and the size will depend on the situation on that market. The Ministry has considered the offer on the Japanese market with a public issue.
- The deputy finance minister W. Kowalczyk highlighted that the scale of foreign issue in 2013 should be smaller than in 2012. But the MF would like to take advantage of the historically lowest cost of foreign issues to secure FX payments in the first two months of next year (around €4bn).
- At the beginning of 2013 the Ministry also plans to draw loans from international institutions (EIB, the World Bank), Value of loans from EIB will probably be higher than from the World Bank (at €750m).

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	3,549	10,000	4,000	0	83,011
T-bills auction	2,223	5,778	3,000										10,330
Retail bonds	216	248	212	210	210	210	150	156		150	150	150	2,071
Foreign bonds/credits	7,979	2,200	0	5,390	1,251	9,675		3,075	6,200				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**	**9,759**	**10,150**	**4,150**	**150**	**162,781**
Redemption	11,297	3,981	5,275	20,795	4,906	2,778	20,459	3,191	1,122	17,603	2,256	2,368	96,032
Net inflows	**41,540**	**15,749**	**8,496**	**-6,183**	**4,896**	**12,080**	**-14,467**	**4,450**	**8,636**	**-7,453**	**1,894**	**-2,218**	**66,749**
Rolling over T-bonds	6,309			7,966		2,459	4,908						**21,641**
Buy-back of debt*													**0**
Total	**47,848**	**15,749**	**8,496**	**1,782**	**4,896**	**14,539**	**-9,559**	**4,450**	**8,636**	**-7,453**	**1,894**	**-2,218**	**88,390**
Coupon payments	*1,451*			*7,211*			*1,497*		*1,455*	*8,038*			*19,741*

*Note: Our forecasts – shaded area, */ expected buy-back of Brady's*

Schedule Treasury Securities redemption by instruments (in PLNm, end of September 2012)

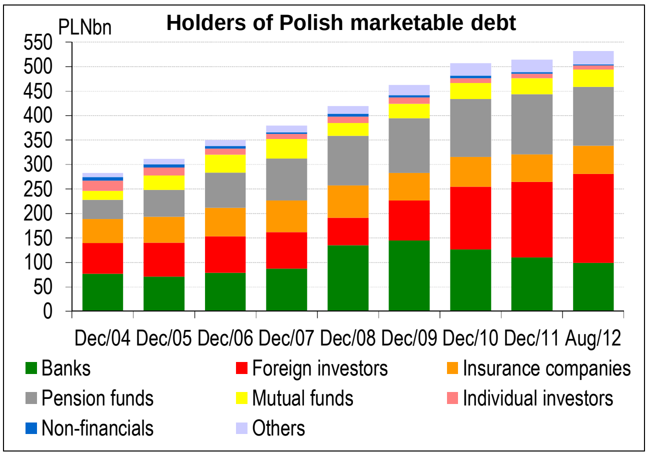
	Bonds	Bills	Retail bonds	Total domestic redemption	Foreign Bonds/Credits	Total redemptions
January	10 946	0	351	**11 297**		**11 297**
February		3 799	182	**3 981**		**3 981**
March		1 997	129	**2 125**	3 150	**5 275**
April	20 663		132	**20 795**		**20 795**
May		2 223	117	**2 339**	2 567	**4 906**
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	16,438	0	265	16,703	0	16,703
November	0	1,332	208	1,540	716	2,256
December	0	2,223	146	2,368	0	2,368
Total 2012	62,388	13,571	2,283	78,242	15,891	94,132
Total 2013	80,511	6,110	1,698	88,319	14,825	103,144
Total 2014	58,958		628	59,586	17,448	77,034
Total 2015	78,880		485	79,365	14,329	93,694
Total 2016	59,378		91	59,469	16,871	76,340
Total 2017+	219,667		3,288	222,955	134,966	357,922

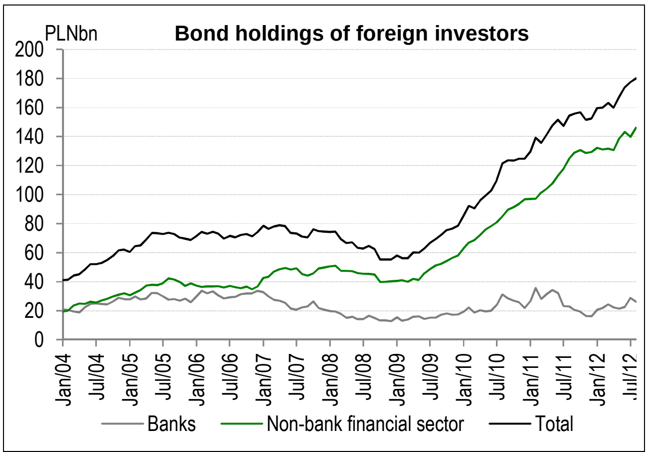
Schedule wholesales bonds redemption by holders (data at the end of August 2012, in PLNm)

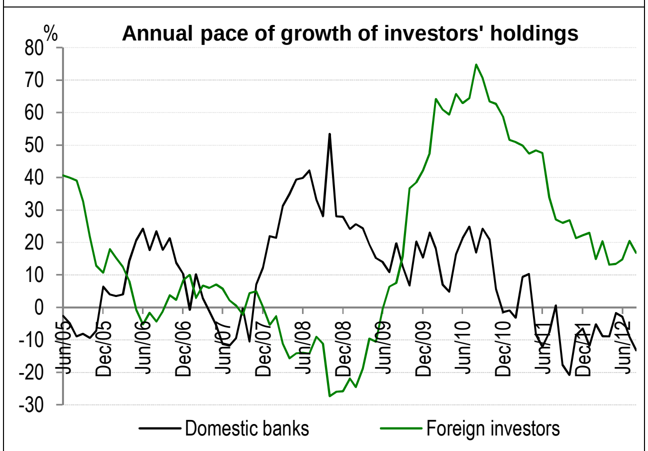
	Foreign investors	Domestic banks	Insurance Funds	Pension Funds	Mutual Funds	Individuals	Non-financial sector	Other	Total
Q1 2012	0	0	0	0	0	0	0	0	0
Q2 2012	0	0	0	0	0	0	0	0	0
Q3 2012	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0
Q4 2012	11,177	5,074	811	1,359	752	84	30	1,010	20,296
Total 2012	**11,177**	**5,074**	**811**	**1,359**	**752**	**84**	**30**	**1,010**	**20,296**
	55%	***25%***	***4%***	***7%***	***4%***	***0%***	***0%***	***5%***	***100%***
Total 2013	38,203	12,073	12,802	11,089	3,264	492	152	4,527	82,602
	46%	*15%*	*15%*	*13%*	*4%*	*1%*	*0%*	*5%*	*100%*
Total 2014	27,830	11,402	5,436	7,866	2,757	437	115	3,405	59,248
	47%	*19%*	*9%*	*13%*	*5%*	*1%*	*0%*	*6%*	*100%*
Total 2015	23,399	18,996	7,205	16,111	5,894	194	765	6,386	78,951
	30%	*24%*	*9%*	*20%*	*7%*	*0%*	*1%*	*8%*	*100%*
Total 2016	14,398	7,865	6,222	24,984	6,332	52	86	2,764	62,704
	23%	*13%*	*10%*	*40%*	*10%*	*0%*	*0%*	*4%*	*100%*
Total 2017+	65,194	38,856	24,055	58,402	15,309	252	567	8,801	211,435
	31%	*18%*	*11%*	*28%*	*7%*	*0%*	*0%*	*4%*	*100%*

Sources: Ministry of Finance, BZ WBK

Treasury Securities Holders







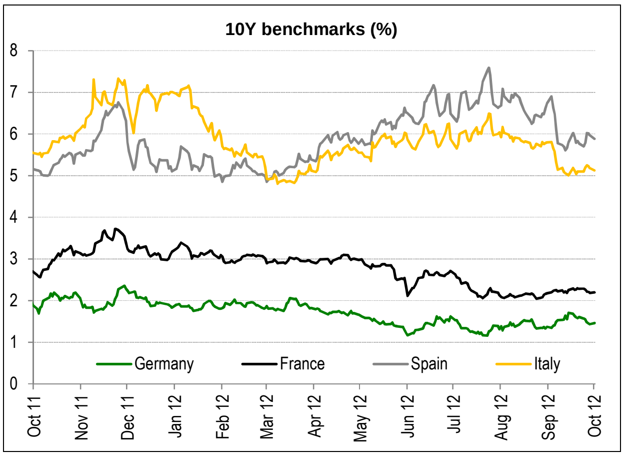
Another record of foreigners' holdings

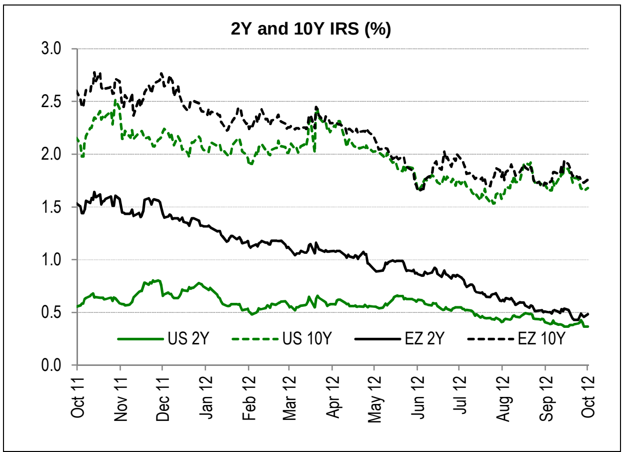
- Foreign investors increased their holdings of Polish PLN-denominated marketable debt for the 4th month in a row and this resulted in 4th record high value of their portfolio. Their share in PLN marketable bonds increased to 34.5% and this group extended the lead over pension funds that occupy 2nd position (with 22.9% share).
- Last month we mentioned that pace at which foreign investors purchase Polish bonds is fading and in August it also was the case. Monthly increase reached PLN2.8bn and was below the 4-month average of PLN5.1bn. It is also worth to notice that annual pace of growth of foreigners' portfolio declined to 16.8% from 20.5% (highest level since January 2012). Furthermore, the downward trend of the annual pace of growth lasts already for two years.
- Director of Debt Department in Ministry of Finance, Piotr Marczak, commented these data by saying that in September the demand from foreign investors for Polish debt was also quite visible.
- Main driver of this record was non-bank financial sector as it increased its holdings by PLN6.5bn. Purchases of this group focused on the short end of the curve (OK0714, OK0114 and DS1013). This indicates that foreign investors clearly believe that the MPC will finally start easing of momentary policy.
- Domestic investors increased the value of held bonds by 0.5%MoM, mainly due to 4.3% increase of mutual funds holdings (highest pace of growth since April 2012). On the contrary, Polish banks continued to reduce their exposure to domestic bonds for a 5th month in a row, but the pace of this tendency lowed in August versus 5-month average (-1.2%MoM vs. -3.2%MoM). This group of holders sold mainly short and medium-term fixed-coupon bonds (DS1015, DS1017, PS1016).

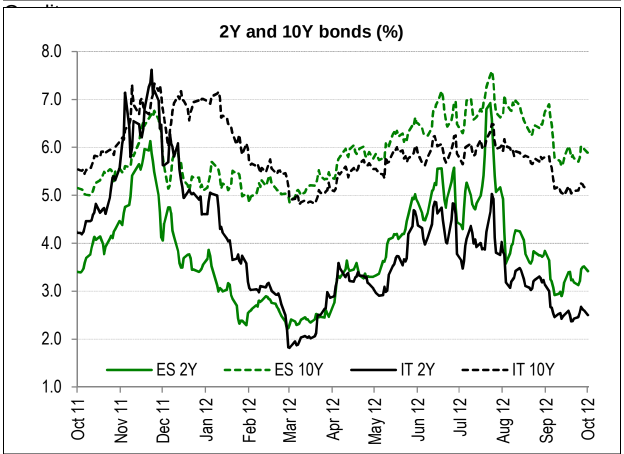
Holders of marketable PLN bonds	Nominal value (PLN, bn)				Nominal value (PLN, bn)			% change in August			Share in TOTAL (%) in August
	End Aug	End July	End Q2 2012	End Q1 2012	End 2011	End 2010	End 2009	MoM	QoQ	YoY	
Domestic investors	342.4	340.8	352.9	361.5	349.8	354.1	336.2	0.5	-	-3.3	65.5
Commercial banks	94.3	95.4	102.1	110.9	103.3	110.4	112.1	-1.2	-	-13.2	18.0
Insurance companies	56.3	55.7	57.0	54.3	55.5	59.5	53.8	1.4	-	-3.6	10.8
Pension funds	119.8	120.6	120.3	120.7	122.2	117.0	111.0	-0.6	-	0.5	22.9
Mutual funds	34.3	32.9	33.0	31.3	31.7	30.2	26.8	4.3	-	20.2	6.6
Others	37.5	36.2	40.5	44.3	37.1	37.0	32.5	7.4	-	2.7	7.2
Foreign investors*	180.2	177.4	174.0	163.2	152.5	124.8	78.6	1.6	-	16.8	34.5
Banks	26.1	28.9	22.6	24.3	16.2	21.9	17.4	-9.4	-	14.1	5.0
Non-bank fin. sector	146.2	139.7	143.1	131.7	129.3	96.8	58.0	4.7	-	17.1	28.0
Non-financial sector	4.9	6.0	5.2	4.4	4.5	4.2	2.3	-18.1	-	21.8	0.9
TOTAL	522.6	518.2	526.9	524.7	502.3	478.9	414.8	0.9	-	2.9	100.0

**Total for Foreign investors does not match sum of values presented for sub-categories due to omission of irrelevant group of investors. Sources: Min Fin, BZ WBK*

International Bond Markets







Flight to quality is still valid…

- In September, international bond market was influenced mostly by the central banks' decisions. As expected, the ECB announced its bond purchase program, named Outright Monetary Transactions (OMT), while in the US, the FOMC decided to resume buying MBS ($40bn per month) and to continue its "Twist Operation" until year-end, keeping ultralow rates at least until mid-2015. As a consequence, yields of Bunds and the US Treasuries (UST) suffered from higher risk appetite, with 10Y benchmark reaching the level of 1.70% in case of Bund and 1.85% in case of the UST. The UST was also negatively affected by signals from Moody's on risk on lowering the US rating.
- Markets' euphoria faded away quicker than had been expected. Rising fears about the effectiveness of planned anti-crisis measures supported demand for safe-haven assets. As a result the UST and German Bunds were trimming previous losses. The weaker-than-expected US macroeconomic data were also negatively influencing market optimism, backing safe assets, which ended September at 1.43% in case of 10Y Bund and 1.61% in case of 10Y UST.
- In short term we do not exclude that both Bunds and UST might continue to gain, especially the front-end of the curve should be well bid. Important support channels are 1.25-1.35% for 10Y Bunds and 1.45-1.55% for 10Y UST.

…but all eyes on Spain

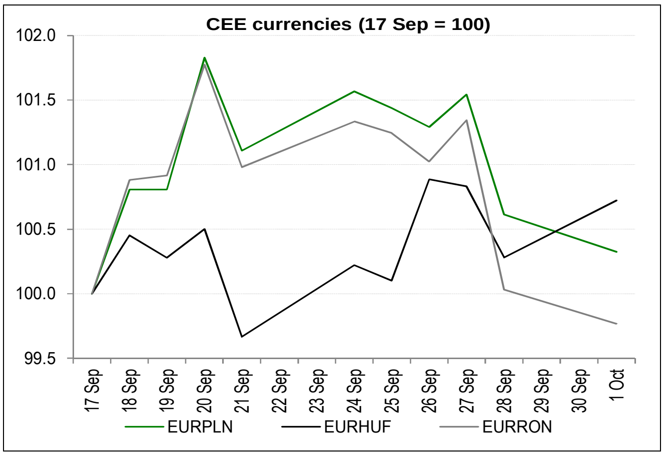
- Peripheral EMU bonds, mainly Italian and Spanish ones, have benefited from a shift in the main central banks' policy (ECB, Fed). The rally extended to bonds across the yield curves and was observed on both primary and secondary markets. Downward move in yields of peripheral bonds was also supported by quite strong auction results, which showed a healthy demand. However, at the end of September Italian and Spanish bonds underperformed due to some investors' mood deterioration (due to uncertainty about possible bailout for Spain and evaluation of reforms in Greece). To sum up, yield of 10Y Spanish bonds fell by 75bps in monthly terms (to 5.99% at the end of September), while yield of 10Y Italian bonds decreased by 62bps to 5.18%.
- Spain's decision about turning for international financial aid will remain a key source of uncertainty in the upcoming weeks. A possible Spanish request for assistance will be the major supporting factor for the euro zone peripheries, but the regional elections (e.g. in Galicia on 21 October) might be important risk. The possibility of a targeted ECB intervention at the short-end of the Spanish and Italian curves should continue to favour short-term instruments in those markets and keep the steepening trend in place.

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

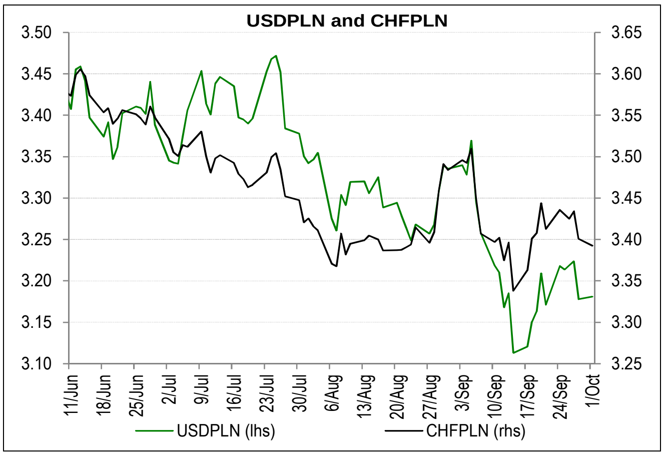
	Total redemptions	Deficit	Borrowing needs	Expected bond supply	% of completion (YtD)
Austria	14	8.3	22.3	21.6	81
Belgium	27.9	7	34.9	31.5	96
Finland	6.3	7.5	13.8	13.8	84
France	101.7	78.7	180.4	178.0	87
Germany	157	26.6	183.6	175.0	80
Greece	33.2	16.2	49.4	-	-
Ireland	5.5	13.7	19.2	-	-
Italy	192.2	41.1	233.3	216.0	62
Netherlands	29.7	12.3	42	60.0	90
Portugal	12.9	17.4	30.3	-	-
Spain	50.1	36.2	86.3	85.9	84
Total	**630.5**	**265.0**	**895.5**	**781.7**	79

Source: Reuters, BZ WBK

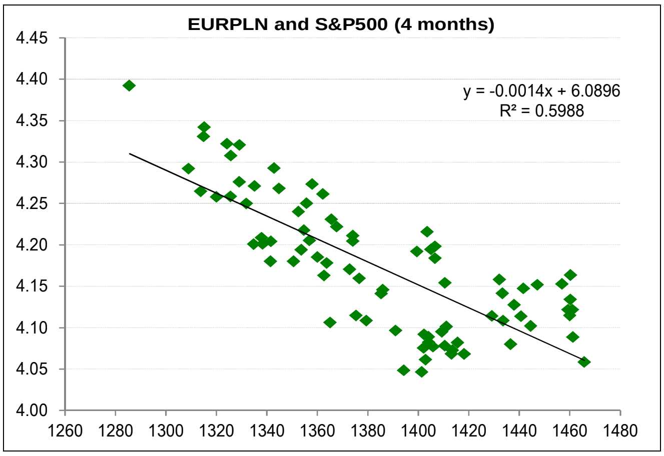
Foreign Exchange Market



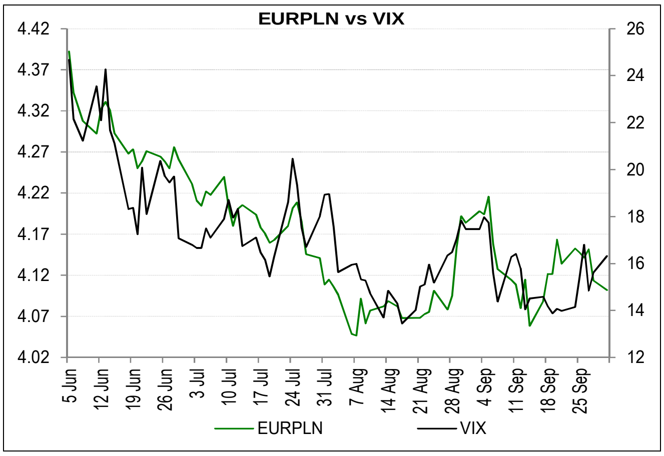
CEE currencies (17 Sep = 100)



USDPLN and CHFPLN



EURPLN and S&P500 (4 months)



EURPLN vs VIX

Sources: Reuters, BZ WBK

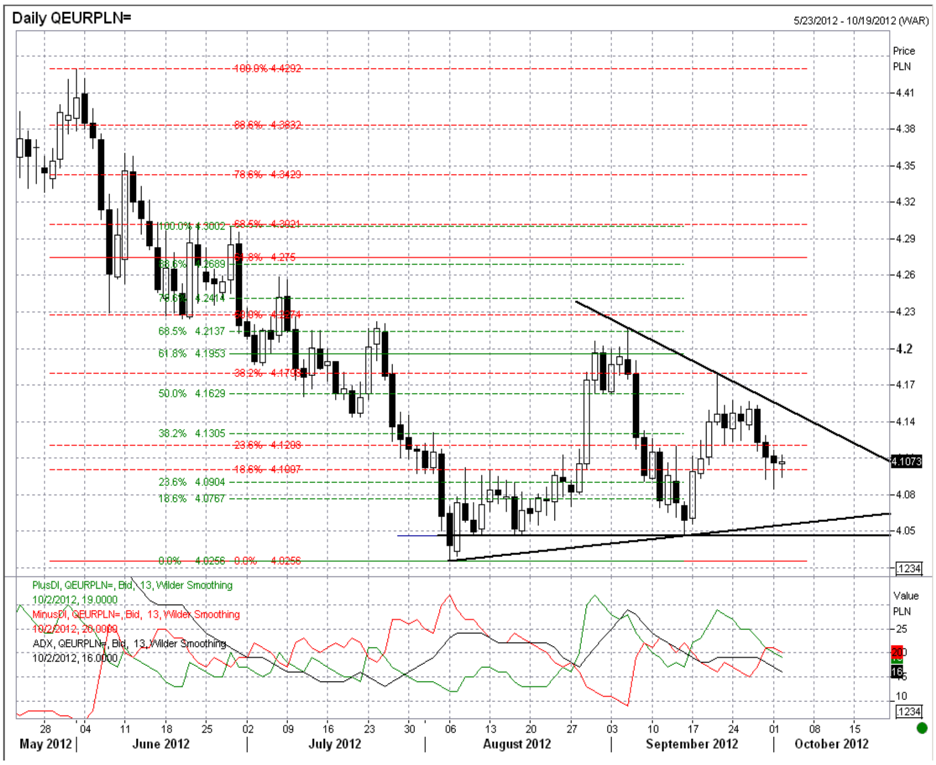
Expectations for rate cuts weigh on the zloty

- The zloty clearly appreciated during the first half of the past month. Main driver of the downward move of the EURPLN was decision taken by the ECB in early September to introduce the Outright Market Transaction program aimed at lowering short term bond yields on the peripheral debt market. Disappointing payrolls data fuelled hopes for Fed's QE3 which also contributed to zloty's appreciation. The EURPLN plunged temporarily to just below 4.05 (lowest level since early August) and the USDPLN tested 3.09 (lowest since early April).
- After the Fed announced its decision, risky assets – including emerging currencies – were hit by profit-taking. However, it is worth to notice that zloty's depreciation was bigger compared to weakening of other currencies. Since mid-September to the local peak the EURPLN increased by 1.8%, while the EURHUF by 0.5%. Other emerging currencies also lost less (MXN, BRL). This may indicate that the domestic currency was under pressure not only due to weakening of other risky assets, but expectations for rate cuts also contributed to depreciation of the zloty.
- The EURPLN ended the month at 4.11, that is 2.0% below level seen at the beginning of September. Versus the dollar the zloty appreciated by 4.8% and versus Swiss franc by 2.7%.

Volatility of the EURPLN may increase in October

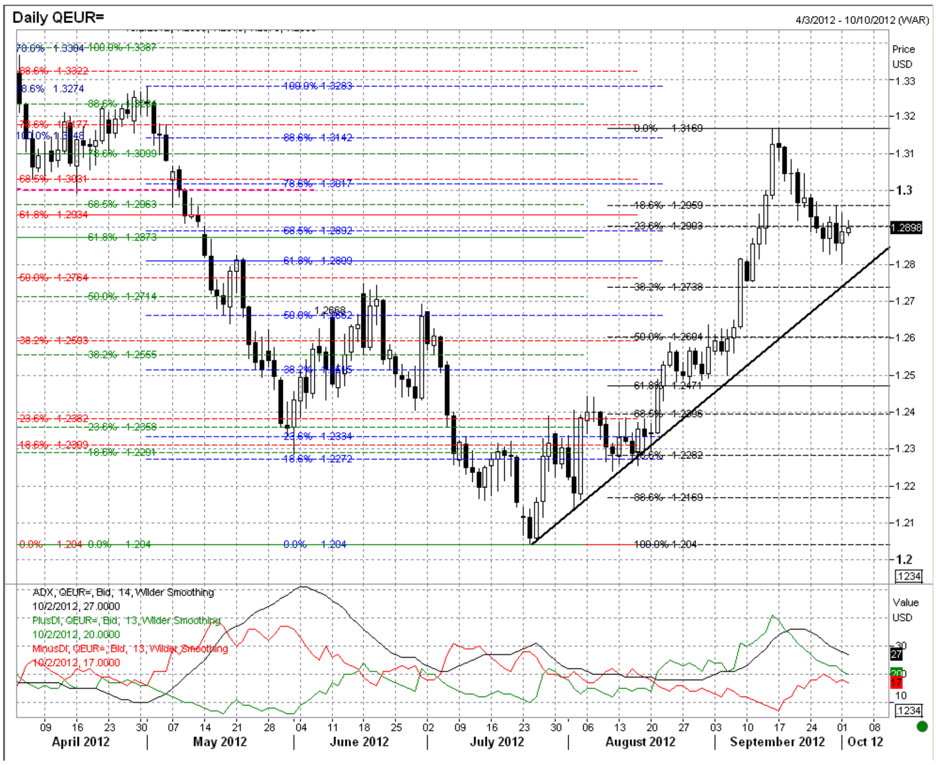
- The zloty continued to be supported by the situation on the US stock market. The 4-month correlation of the EURPLN with the S&P500 eased somewhat during September (from -0.91 to -0.77), but situation on the US stock exchange remains important driver of the EURPLN. Profit-taking that emerged after the Fed was only marginal (so far) and this may indicate that currently there is no additional factor that could encourage investors to reduce the engagement in capital market. Market still hopes QE3 will work and investors do not want to sell stocks in order not to miss any future upward move in prices. Consequently, unless there is increase in risk aversion due to euro zone's problems, there should be no negative sentiment in the stock market. As a result, the zloty is likely to be still supported by situation on the S&P500 (if the correlation does not decline significantly).
- However, in terms of domestic factors, we expect the Polish MPC to cut NBP rates this month and announce this is a beginning of the easing cycle. The outlook of rate cuts and more data releases suggesting the slowdown in the economy should put a negative pressure on the domestic currency. Due to this factor the room for zloty's appreciation will be limited. Upward move of the EURPLN seen in late August after disappointing data on Q2 GDP (that fuelled expectations for rate cuts) showed pretty clearly how important was the hawkish rhetoric of the MPC for the zloty in the previous months
- Furthermore, as the time of the release of Troika's report on the progress Greece has (not) made on implementing reforms is getting closer, the uncertainty regarding further developments in the euro zone is likely to continue to play important role. Recently the market might have been too optimistic when pricing in prompt implementation of steps aiming at stabilising the situation in the euro zone (such as the banking union) as recent comments from Germany and France show different approaches toward the pace of implementing common banking supervisory.
- We expect the average EURPLN to be ca. 4.15 in October. Still, as mentioned above there are many important factors driving the FX market and thus the exchange rate may temporarily test lower and upper band of range in which EURPLN stays since mid-August (4.05-4.20).

FX Technical Analysis Corner



EURPLN

- The resistance at 4.20-4.22 which we pointed last month was tested but the EURPLN did not manage to break it.
- In general, the situation on the market did not change significantly during the past month, thus the technical analysis does not send any clear signals for the time being.
- The MinusDI increased over the PlusDI (lines that help to identify the current trend) and this may suggest the downward trend may be initiated. The upper band of triangle may be drawn and the exchange rate might attempt to head towards 4.05-4.06 in the following days. Still, so far the strength of the downward trend (measured by ADX) is rather low.
- In October the exchange rate may test upper and lower band of the consolidation channel between 4.05 and 4.20.



EURUSD

- The exchange rate surged during the past month. The upward move exceeded the projected H&S target (ca. 1.27) and reached nearly 1.32.
- The ADX oscillator points the strength of the upward trend abated in recent days. Still, the DI+ (green one on the chart) remains above DI- (red one) and as the EURUSD did not break the line of upward trend it is too early to announce upcoming euro's depreciation.
- If the EURUSD breaks 1.32 then it may rise further to 1.34.

Sources: Reuters, BZ WBK

Poland vs other countries - economy

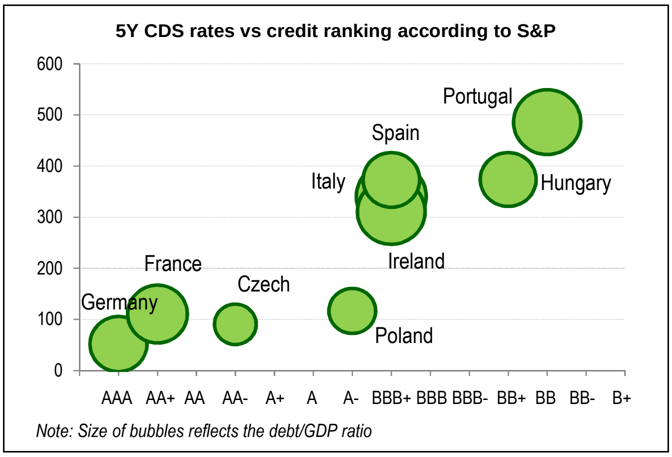
Main macroeconomic indicators (European Commission's forecasts)

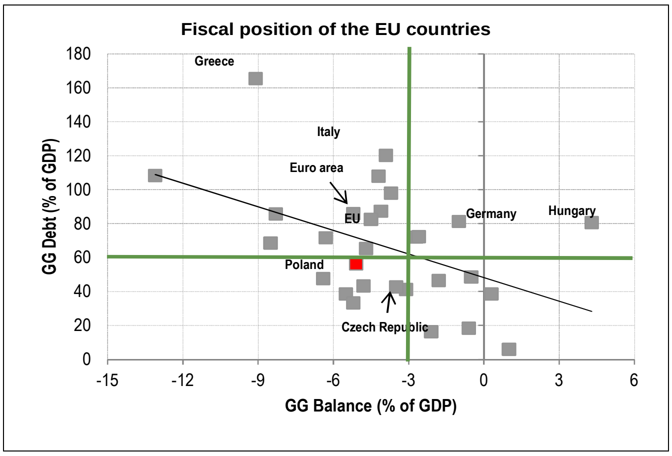
	GDP* (%)		Inflation* (HICP, %)		C/A balance (% of GDP)		Fiscal Balance (% of GDP)		Public Debt (% of GDP)	
	2012F	2013F	2012F	2013F	2012F	2013F	2012F	2013F	2012F	2013F
Poland	**2.7**	**2.6**	**3.7**	**2.9**	**-3.9**	**-4.2**	**-3.0**	**-2.5**	**57.1**	**57.5**
Czech Republic	0.0	1.5	3.3	2.2	-3.2	-3.2	-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

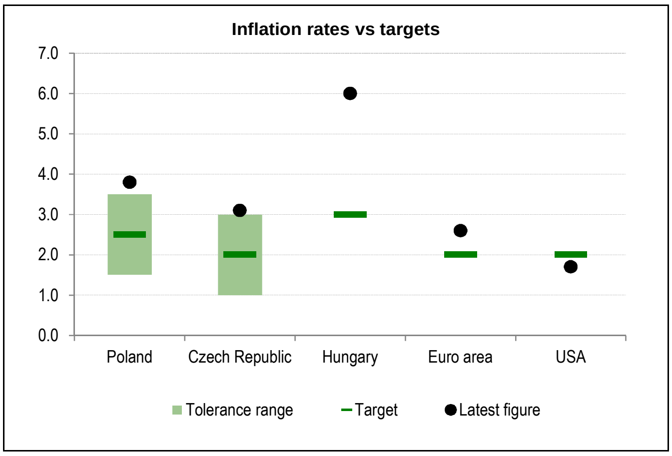
*Note: * European commission – May 2012*

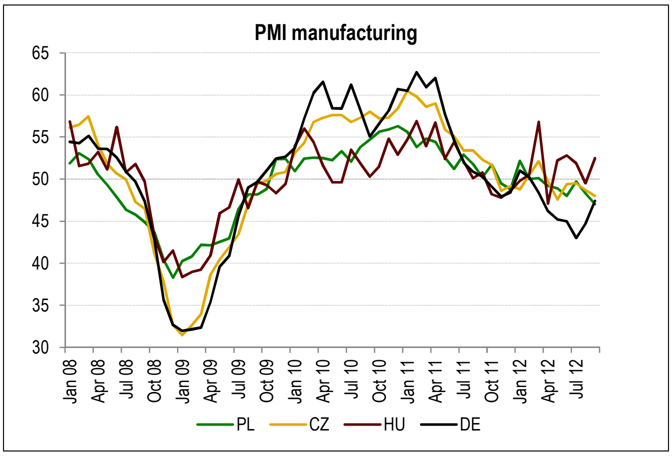
Sovereign ratings

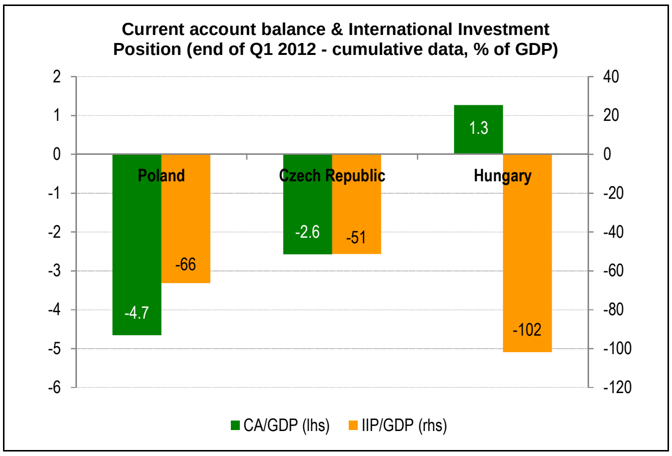
	S&P		Moody's		Fitch	
	rating	outlook	rating	outlook	rating	outlook
Poland	A-	stable	A2	stable	A-	stable
Czech	AA-	stable	A1	stable	A+	stable
Hungary	BB+	negative	Ba1	negative	BB+	negative
Germany	AAA	stable	Aaa	negative	AAA	stable
France	AA+	negative	Aaa	negative	AAA	negative
UK	AAA	stable	Aaa	negative	AAA	negative
Greece	CCC	negative	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









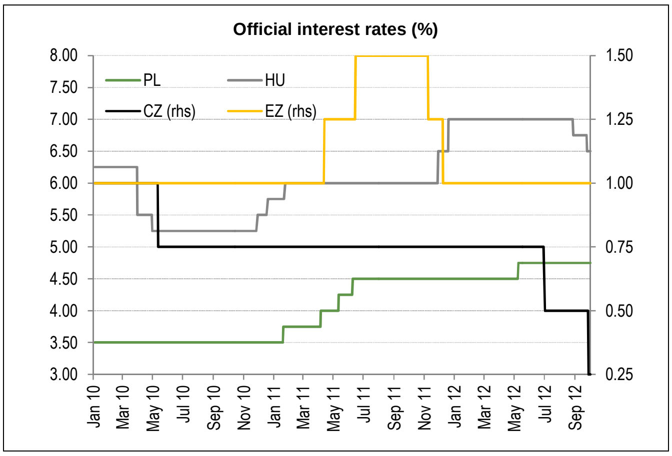


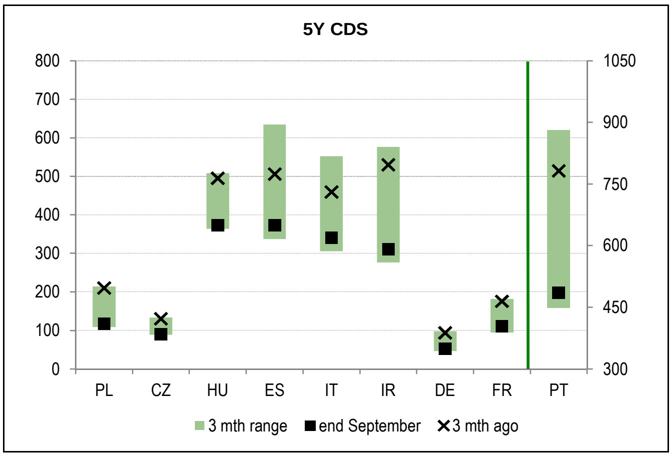
Source: stat offices, central banks, Reuters. BZ WBK, EC

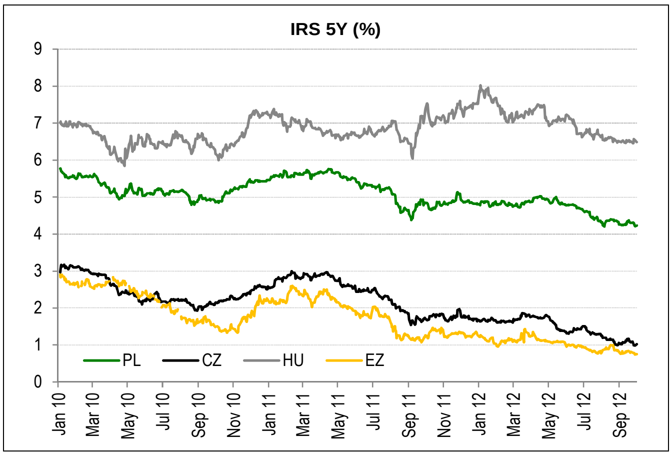
Poland vs other countries - market

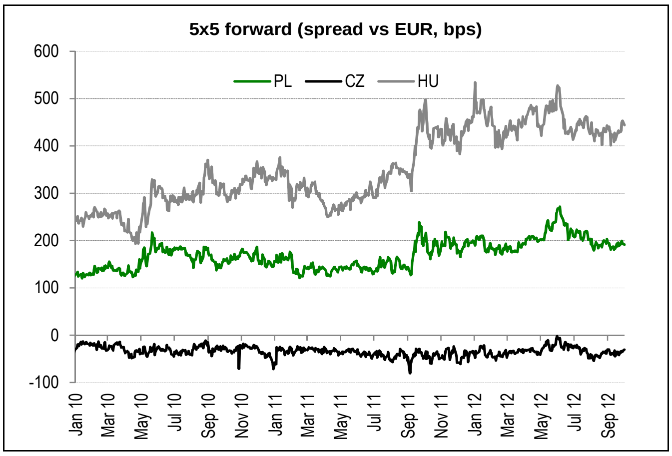
Main market indicators (%)

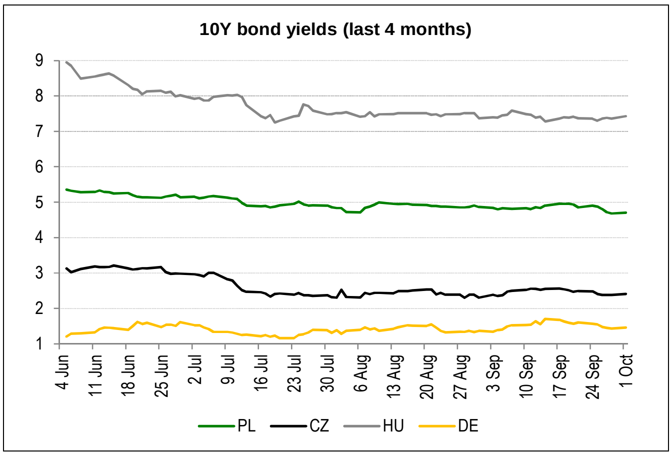
	Reference rate (%)		3M market rate (%)		10Y yields (%)		10Y Spread vs Bund (bps)		CDS 5Y	
	2011	2012F	2011	end of September	2011	end of September	2011	end of September	2011	end of September
Poland	**4.50**	**4.25**	**4.99**	**4.92**	**5.88**	**4.69**	**405**	**325**	**279**	**119**
Czech Republic	0.75	0.50	0.78	0.47	3.59	2.38	176	95	173	91
Hungary	7.00	6.50	7.24	6.61	9.90	7.36	807	593	610	378
Euro area	1.00	0.50	1.36	0.22						
Germany					1.83	1.43			100	54

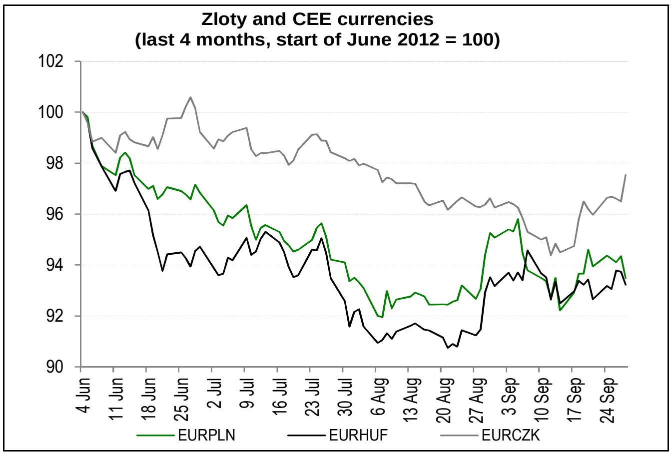

Official interest rates (%)


5Y CDS


IRS 5Y (%)


5x5 forward (spread vs EUR, bps)


10Y bond yields (last 4 months)


Zloty and CEE currencies (last 4 months, start of June 2012 = 100)

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

Central Bank Watch

					Expected changes (bps)			Risks
		Last	2011	2012F	1M	3M	6M	
Euro	Forecast	0.75	1.00	0.50				We expect the refi rate to be on hold, but the risk for a rate cut gradually increases
	Market implied »				0	0	-4	
UK	Forecast	0.50	0.50	0.50				The September's MPC minutes suggest rates on hold, but expansion of bond purchasing program is possible
	Market implied »				-4	-8	-8	
US	Forecast	0-0.25	0-0.25	0-0.25				Rates on hold. Jobs report is crucial
	Market implied »				0	-3	-4	
Poland	Forecast	4.75	4.50	4.25				Due to more cautions and less dovish stance the MPC might decide to keep rates unchanged in October
	Market implied »				-18	-50	-93	
Czech	Forecast	0.25	0.75	0.25				The CNB decreased rates to record low. The Bank might implement unconventional measures if economic activity continues to deteriorate
	Market implied »				20	1	0	
Hungary	Forecast	6.50	7.00	6.50				In September, the NBH cut rates by 25bps. Higher inflation rate readings might postpone further monetary extensions
	Market implied »				-2	-42	-76	

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

Economic Calendar and Events

Date		Event:	Note:
3-Oct	**PL**	**MPC Meeting – interest rate decision**	**We foresee the MPC to cut rates by 25bps**
4-Oct	**PL**	**Auction of WZ0117/PS0417/WZ0121**	**Offer: PLN3.0-5.0bn**
	EZ	ECB Meeting – interest rate decision	Rates on hold
	ES	Auction of 2Y, 3Y and 5Y bonds	Offer: €3.0-3.5bn
	US	Minutes from September's FOMC meeting	
8-Oct	EZ	Eurogroup meeting	-
9-Oct	EU	ECOFIN meeting	-
9-12 Oct	US	Annual meeting of IMF and World Bank Group	
10-Oct	DE	Auction of 5Y bonds	Offer: €4.0bn
11-Oct	IT	Auction of medium and long term bonds	-
15-Oct	**PL**	**CPI inflation for September**	**Our forecast: 4.0%YoY, in line with market consensus**
16-Oct	**PL**	**Wages and employment for September**	**We expect moderate wages growth (by 2.7%YoY) and employment increase near zero**
17-Oct	**PL**	**Industrial output for September**	**Our forecast is the most pessimistic on the market (-7.1%YoY vs expected -4.1%YoY)**
	DE	Auction of 2Y bonds	Offer: €5.0bn
18-Oct	**PL**	**Minutes from September's MPC meeting**	**-**
18-19 Oct	EU	EU Summit	
22-Oct	**PL**	**Core inflation measures for September**	**We expect core inflation exc. food & energy prices at 2.1%YoY, in line with market predictions**
23-Oct	**PL**	**Auction of OK0714 and DS1023**	**Offer: PLN5.0-9.0bn**
23-24 Oct	US	FOMC Meeting - interest rate decision	-
24-Oct	DE	Auction of 10Y bonds	Offer: €4.0bn
30-Oct	HU	NBH Meeting – interest rate decision	-
31-Oct	DE	Auction of 30Y bonds	Offer: €2.0bn
1-Nov	CZ	CNB Meeting - interest rate decision	-
7-Nov	**PL**	**MPC Meeting – interest rate decision**	**We foresee the MPC to cut rates by 25bps**

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	1,597.6	1,665.8	370.5	388.4	392.9	445.9	385.5	404.1	409.2	467.0
GDP	%YoY	3.9	4.3	2.2	1.9	3.5	2.4	1.7	1.5	1.3	2.0	2.0	2.2
Domestic demand	%YoY	4.6	3.6	-0.1	1.1	2.7	-0.2	-1.1	-1.2	-0.4	0.5	2.2	1.9
Private consumption	%YoY	3.2	3.1	1.7	1.7	2.1	1.5	1.5	1.6	1.6	1.7	1.8	1.9
Fixed investments	%YoY	-0.4	8.1	0.0	-2.7	6.7	1.9	-2.0	-2.0	-5.0	-4.0	-3.0	-1.0
Unemployment rate [a]	%	12.4	12.5	13.5	13.9	13.3	12.4	12.5	13.5	14.0	13.2	13.3	13.9
Current account balance	EURm	-18,129	-17,977	-12,195	-6,836	-4,515	-2,164	-2,941	-2,575	-2,182	-804	-2,144	-1,705
Current account balance	% GDP	-5.1	-4.9	-3.2	-1.7	-5.1	-4.6	-4.0	-3.2	-2.6	-2.2	-2.0	-1.7
General government balance	% GDP	-7.8	-5.1	-3.5	-3.0	-	-	-	-	-	-	-	-
CPI	%YoY	2.6	4.3	3.8	2.4	4.1	4.0	3.9	3.2	2.6	2.1	2.4	2.5
CPI [a]	%YoY	3.1	4.6	2.9	2.4	3.9	4.3	4.0	2.9	2.4	2.0	2.5	2.4
CPI excluding food and energy prices	%YoY	1.6	2.4	2.3	2.0	2.5	2.5	2.2	1.9	2.0	1.8	2.1	2.1
EUR/PLN	PLN	3.99	4.12	4.20	4.15	4.23	4.26	4.14	4.17	4.21	4.15	4.15	4.10
USD/PLN	PLN	3.02	2.96	3.27	3.21	3.23	3.32	3.31	3.24	3.33	3.26	3.17	3.08
CHF/PLN	PLN	2.90	3.34	3.48	3.37	3.50	3.55	3.44	3.45	3.51	3.39	3.32	3.28
GBP/PLN	PLN	4.66	4.75	5.18	5.01	5.26	5.34	5.22	5.19	5.13	5.07	4.94	4.91
Reference rate [a]	%	3.50	4.50	4.25	4.00	4.50	4.75	4.75	4.25	4.00	4.00	4.00	4.00
WIBOR 3M	%	3.94	4.54	4.93	4.26	4.97	5.04	5.06	4.65	4.32	4.23	4.25	4.22
Yield on 2-year T-bonds	%	4.72	4.81	4.40	3.97	4.66	4.71	4.22	4.01	3.93	3.90	3.98	4.07
Yield on 5-year T-bonds	%	5.31	5.44	4.63	4.15	5.02	4.93	4.43	4.13	4.07	4.08	4.18	4.27
Yield on 10-year T-bonds	%	5.74	5.98	5.14	4.85	5.58	5.38	4.91	4.69	4.80	4.86	4.88	4.87

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

This analysis is based on information available until 1st October 2012 and has been prepared by:

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