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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of March 19th 2010 to March 25th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Core inflation	Mar 22	Feb	**2.3-2.4%**	2.3%	2.5%	Revision of consumption basket influences the readings of core inflation. Moderate momentum of inflationary processes.

In Focus / Macroeconomics

Macro data confirm recovery in manufacturing and falling inflation

This week we had plenty of publications. In just few points: i) inflation (also on the producers' side) is falling, ii) real sphere recovery (manufacturing) is still on track, iii) labor market sent off mixed signal, although we think the temporary weakness is weather-related (fresh data from regional labor offices indicate that the absolute number of unemployed is falling), iv) owing to very poor construction spending and another drop in VAT revenues (on annual basis) poses some serious risk to Q1 GDP forecast, however, eventual dip in Q1 (in terms of growth rate) should not be regarded as a change in trend but as a seasonal bump.

Prices. CPI inflation in February hit 2.9% y/y. Revision in the consumption basket (among the major ones: higher weight attached to lodging and restaurants and hotels, lower to foods) has brought January CPI to 3.5% y/y (from previously announced 3.6%). We see core inflation (to be released next week) at 2.3-2.4% y/y. Inflationary processes in Poland seem to exhibit rather neutral momentum.

February saw a contraction of producer prices by 0.1% on monthly basis. Driven by statistical base effects (massive EURPLN depreciation from 2009 backed by unanticipated gas and electricity hikes), annual growth rate plunged to -2.4%. As for manufacturing, the dip in prices was full 0.2% m/m. Excluding energy, manufacturing prices are running 5.3% below last year's level. Next months are likely to only firm the ongoing tendency. It is likely that not only domestic suppliers are struggling to retain their price competitiveness in the local markets, but also exporters need to retain customers (mind the recent PLN appreciation), affecting thereby also domestic prices. Disinflation in producer prices is running at full throttle (there seem to be some potential of pass through to consumer prices, backing thereby the effect of high last year's statistical base).

Labor market. February saw corporate wages rising by 2.9% up from 0.5% y/y recorded in January. The return of annual growth rate to its mid-term trend is mainly attributable to offsetting the one offs present in December and January data, which were caused by tax related wage payment delays at the end of 2008. Thus the data confirmed that there are no signs of wage deflation in the Polish economy. On the back of stabilizing labor market we expect wages to rise steadily at the rates close to 4% in the months to come.

Employment in enterprise sector shrank by 8k during February (annual growth rate rose on statistical base effects to -1.1 y/y). Even after smoothing out the January rise in employment which was led primarily by one-off factors, February reading seems a bit off-track. However, there are some sensible arguments – mainly the temperature-led fall of final demand in construction and retail – to consider them potentially downwards distorted. On the basis of solid momentum in business tendency indicators (rising hiring plans of enterprises, which are potentially free of unusual seasonal effects) we remain optimistic on the labor market. What is more, falling underutilization and slowly closing gap between the contemporary and average workweek (we may only extrapolate trends form quarterly surveys, though) should result in rising employment within some months. Till then we remain at 0+ range and wait for detailed data to confirm the extraordinary features of February data.

Industrial output. February saw industrial production growing at 9.2% vs. 8.5% y/y recorded in January. Higher annual dynamics partially reflects higher positive working day effect (+2 y/y). In seasonally-adjusted terms industrial production slowed from 2.5% to 0.9%, which along with the base effect from February 2009 (we saw quite a strong output rebound then) translated into lower annual seasonally-adjusted dynamics of 9.5% vs. 11.1% seen in January. Momentum remains very positive. We think the tendency is going to continue in the months to come (see a record high new orders in German industry).

Arctic weather conditions proved to be irrelevant for industrial production but it is very likely they adversely affected construction, which dropped by 24.6% in February. That is why we see a downside risk to Q1 GDP dynamics (apart from lower investment there is a risk of lower consumption), which we estimate at sub 3.0% level. We do not see a one-offs driven Q1 as an indication of a new economic slowdown, though.

MPC outlook. Next months will be marked with monotonically falling inflation what is inextricably linked to base effects from the last year. Despite the fact that such a behavior of prices was largely anticipated, we expect the dovish side of the MPC to run at the fore soon (we also cannot exclude further dovish comments from the hawkish camp). The period of steep (statistical) disinflation (regardless of the cause…) seems a good excuse for the MPC members to concentrate more on the issues centered around PLN stability and GDP growth (the MPC still seems to be neglecting the sustainability of upswing in manufacturing, and remains cautious on the labor market). We do not expect the MPC to turn more hawkish sooner than the phase of the upswing finds confirmation on consecutive sets of macro data (they need to be really convincing…). As for exact hikes, late H2 seems the soonest possible date. This development coincides with the global tendency of subsiding expectations for abrupt monetary policy normalization.

Fiscal outlook. The Ministry of Finance recently announced that the budget deficit shot up to PLN 16.7 bn. after February. The Ministry claims the growth matched the previously announced plan. Indeed, there were some one-off payments (some to state insurance fund, some to local communities in order to conclude wage deals with teachers). However, sharp rise in deficit was also led by lower revenues (CIT, PIT, VAT still under water) and is somehow connected with a dip in domestic demand in January-February (possibly weather related). Summing up, the budget data increase the risk that the whole year deficit will come close to the plan. Although we still believe that tax revenues, along with as high as PLN 8bn central bank profit (as Reuters quoted from the “NBP related source”), are very likely to ultimately support lower deficit, the risk remains and deserves careful monitoring. Growing risk is likely to be acknowledged by the Ministry as well which may result in even more active play with debt supply and retaining high liquidity margin. We cannot even rule out the temporary freezing of some expenditures (just as is was in Q2 2009) to support investors optimism towards Polish debt.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3+	4.5
Inflation rate (%, average)	2.4	4.3	3.5	2.3	2.9
Current account (% of GDP, average)	-4.5	-5.3	-1.5	-2.3	-3.7
Unemployment rate (end-of-year)	11.4	9.5	11.9	12.1	10.9
NBP repo rate (end-of-year)	5.00	5.00	3.50	4.00	5.50

Indicator	2009				2010	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	0.8	1.1	1.7	3.1	3.0	3.3
Inflation rate (%, average)	3.2	3.7	3.5	3.5	3.3	2.1
NBP repo rate (end-of-quarter)	3.75	3.50	3.50	3.50	3.50	3.50

Bold denotes chages from the last release with arrows showing the direction of chages

Fixed Income

Never-ending rally?

Last week seemed to be the most spectacular and busy one this year. Although the yield curve, trading in a 15-20bp range for the couple of weeks, reached its support levels (2Y 4.88-5.08 , 5Y 5.47-5.67) the still existing strong demand on Polish government bonds pushed the curve down rapidly to the new lows. Both more dovish comments from the MPC members and the possible limited bonds supply in the second half of the year sparked the heavy receiving interest down the curve. The most popular security DS1019 went up from 97.55 to 99.55 yielding 5.83% to 5.56% respectively. The bullish flattening process on the bond curve had unfortunately a little impact on a swap curve leaving 5Y10Y spread around the highest level of the year of 18-19bp due to the still existing strong paying interest in 5Y5Y FWD EUR/PLN. That resulted in further asset spreads narrowing of another 10bp (from 15 to 05 on DS1019). The Wednesday's t-bond auction was a great success again. Ministry of Finance sold total of 3.6 bln of WZ0121 6MWibor-linked FRN at around +35 over swap curve with a spectacular demand of over 15 bln.

Short end of the curve. The bullish market pushed the front end curve rates to the Wibor levels with 3x6s traded at 4.13% and 1x4s traded even below. As the September's 6x9s is trading 10 point over Wibor rate and December's 9x12s 35 points we see the aforementioned spreads widening on a very likely at least one interest rate move up.

Despite the MPC is constantly sending the dovish comments to the market suggesting the lack of interest rate moves this year we still believe that the June's CPI projection is likely to show the higher path of the future inflation that will force MPC to act sooner or later. That is why the short end of the FRA curve does not have to fall immediately. Our base scenario also assumes the total of 100-150bp interest rate hikes in the next cycle. As the MPC is seemed to play its own internal tactical game at the moment suggesting to postpone the need of rate hikes, we think the FRA curve need to be steeper. So, 1Y1Y FWD may went up from current 5.12%.

Long end of the curve. We still believe the 10y sector has the quite good value and we won't be surprised to see it yielding at 5.00%, the short term correction may be in cards however.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.456%	5/4/2009
52 Week T-bills	3/22/2010	-	3.923%	3/15/2010
2Y T-bond OK0712	4/7/2010	-	4.895%	3/10/2010
5Y T-bond PS0415	4/14/2010	-	5.736%	12/2/2009
10Y T-bond DS1019	4/21/2010	-	6.103%	2/19/2010
20Y T-bond WS0429	4/21/2010	-	6.170%	9/23/2009

Money Market

Temporary squeeze

Temporary squeeze since the banks bought PLN 70 billion of money bills, despite of the fact that the central bank itself indicated in its projection a substantial shortage of the cash if such an amount would have been purchased. Quite an interesting issue is the fact that the central bank forecasts the shortage and still offers the amount of money bills that would be the direct cause of it. Even more interesting is the fact that banks seeing it still purchase the bills in excess amounts. We see no reasonable explanation for the latter issue. The first one, however, can be explained by the fact that the central bank is operating on an average values for the system. It is not the best thing to do when the market liquidity is highly asymmetric. Therefore, the most probable scenario for tomorrow's auction would be buying much less bills and pushing the cost of carry down. If its true the rest of the month should be cheap.

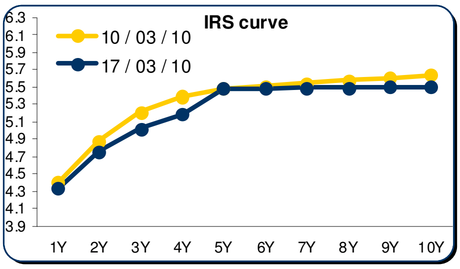
Further restrictions on the quantitative easing of the monetary policy

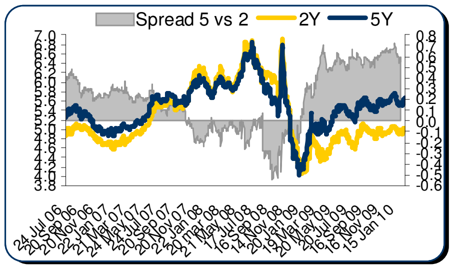
Further restrictions on the quantitative easing of the monetary policy has been implemented. The 6M repo, the USDPLN and EURPLN swaps with the central bank will be ceased as of the 1st of April.

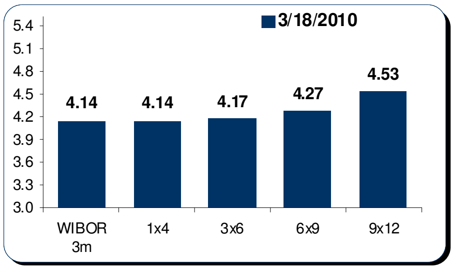
Bullish sentiment well supported

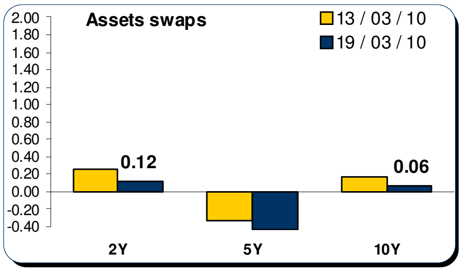
Better then expected CPI figure (2.9% vs 3%) along with the FED's bullish comment and also many bullish comments from the MPC side, strengthen positive sentiment for Polish interest rates. All goes well towards our previous expectations that rates hikes, if any, will be done no sooner that in 4th quarter.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Złoty stronger

Although part of MPC prefer to see the weaker zloty, there is no doubt global sentiment is a main factor, which determines zloty trend in short/medium term. Growing risk appetite, even strengthen by S&P statement about Greece rating (Greece banks were taken off from the negative watch list) has driven EURPLN to trade at 3.86 again. However, because of decent market positioning (long PLN) trend appears to be exhausting, investors still feels comfortable with PLN longs.

Implied volatility lower

It's a fourth week, once realized volatility, calculated in a weekly terms, is ranged between 5.0-8.0%. Adding that to strong zloty, explains lower EURPLN and USDPLN curves. Both curves were traded at this year lows: EURPLN 1M 9.0, 1Y 11.3, USDPLN respectively 14.25 and 16.5. USDPLN curve reflects also the fact that, EURPLN vs EURUSD correlation has decreased down to -0.25 (currency spread (USD/PLN vs EUR/PLN) is now 5.25% in comparison with 6.5% and correlation -0.75 during Greek crisis).

Short-term forecasts

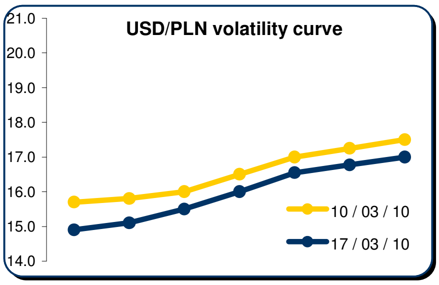
SPOT

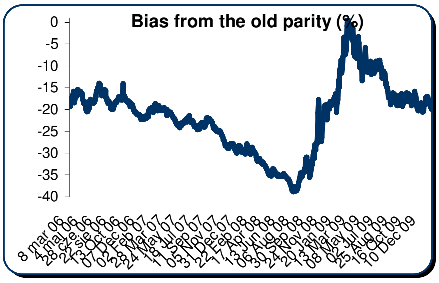
Main supports / resistances:
EUR/PLN: 3.8000 / 4.0000
USD/PLN: 2.8000 / 3.9500

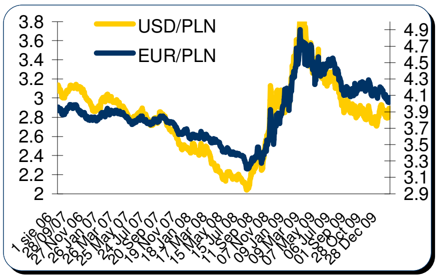
Present trend is targeting 3.80. Any corrections may go towards 3.9500/3.9700 level which seem appropriate to exploit fundamental appreciating trend in the zloty.

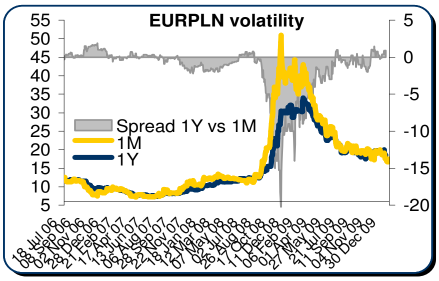
OPTIONS
The volatility curves were sliding to their lows, because of the falling realized volatility and the stronger zloty. For those who believe in short-term upside correction, buying 1-month RR's for upside gamma or 6 month RR for positive Vanna profile seems a good option.

FX CHARTS


USD/PLN volatility curve
10 / 03 / 10
17 / 03 / 10


Bias from the old parity (%)


USD/PLN
EUR/PLN


EURPLN volatility
Spread 1Y vs 1M
1M
1Y

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
11/03/10	4.00%	4.13%	4.05%	4.14%	4.25%	4.33%
12/03/10	3.98%	4.13%	4.11%	4.13%	4.30%	6.59%
15/03/10	4.03%	4.13%	4.06%	6.49%	4.30%	4.33%
16/03/10	4.06%	4.12%	4.13%	4.12%	4.32%	4.33%
17/03/10	4.01%	4.14%	4.12%	4.13%	4.32%	4.34%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
11/03/10	4.19%	4.18%	4.39%	4.70%	4.59%
12/03/10	4.17%	4.17%	4.32%	4.63%	4.55%
15/03/10	4.14%	4.18%	4.31%	4.60%	4.50%
16/03/10	4.13%	4.16%	4.23%	4.50%	4.41%
17/03/10	4.14%	4.14%	4.22%	4.47%	4.43%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0709	IRS	PS0511	IRS	DS1017
11/03/10	4.33%	3.82%	4.86%	4.50%	5.48%	5.07%	5.62%	5.68%
12/03/10	6.59%	3.79%	4.79%	4.57%	5.48%	5.14%	5.60%	5.77%
15/03/10	4.33%	3.82%	4.78%	4.50%	5.48%	5.07%	5.53%	5.68%
16/03/10	4.33%	3.81%	4.76%	4.52%	5.48%	5.02%	5.50%	5.63%
17/03/10	4.34%	3.81%	4.76%	4.45%	5.48%	5.05%	5.50%	5.56%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/03/08	11/03/08	96.173	3.94%	1000	1900	1000
OK0712	10/03/10	12/07/25	89.280	4.90%	5400	17000	5448
PS0415	09/12/02	15/04/25	98.691	5.78%	5000	5614	3629
DS1019	10/02/19	19/04/25	95.629	6.10%	2000	5570	2000

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
11/03/10	15.30	16.10	16.75	17.25	2.50	3.70	0.60	0.90
12/03/10	15.25	16.10	16.65	17.10	2.50	3.70	0.60	0.90
15/03/10	15.10	16.00	16.55	17.00	2.50	3.70	0.60	0.90
16/03/10	14.90	15.75	16.45	16.85	2.50	3.70	0.60	0.90
17/03/10	14.70	15.50	16.35	16.75	2.50	3.70	0.60	0.90

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
11/03/10	2.8561	3.9006	-19.49%
12/03/10	2.8312	3.8923	-20.33%
15/03/10	2.8449	3.9010	-20.13%
16/03/10	2.8393	3.8870	-20.62%
17/03/10	2.8083	3.8684	-20.90%

Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50

Mid-market volatility of vanilla option strategies

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