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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of June 25th 2010 to July 1st 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
MPC Decision	Jun 30	-	**3.5%**	3.5%	3.5%	A breeze of hawkishness from some rate-setters. Combination of MPC comments and stronger real sphere data (and possibly PPI surge) constitute a minor point risk (limited to this very meeting only) of bias change.
MinFin's inflation forecast	Jul 1	Jun	**1.9-2.0%**	-	2.2%	Minor rises in fuels, Food prices above seasonal pattern.
PMI Index	Jul 1	Jun	**51.9%**	-	52.2%	A slight turnaround in domestic situation reflected in SA business tendency indicators but falling PMIs abroad and overall pessimism may drag the PMI further down.

In Focus / Macroeconomics

A series of (not-always positive) surprises

Last days proved to be quite surprising. On the macro side we had a very decent growth of industrial output and retail sales. On the other hand, presidential elections have not confirmed Komorowski easy-win scenario and his advantage over Kaczynski shrank to only 5pp. – half of the margin stipulated by the earlier public opinion polls. Second round of the elections may add a little trill then, but Komorowski's victory seems secured.

Industrial output and producer prices. Industrial output grew by stunning 14%, reaching thereby almost twice the market consensus. Such a solid growth stood at odds not only with business tendency indicators provided by the Central Statistical Office (GUS), but also with the PMIs which leveled-off a bit in May. Quick look at the leading manufacturing sections reveals the drivers of growth remain at highly export-oriented enterprises (electronics, metal industry), which – given additional competitive boost given by 5% weaker zloty, might have been able to swiftly manage their spare capacities and meet rising orders from abroad (especially from the German economy). Owing to the further rises of Ifo Business Situation index (which reflects mainly a decent flow of orders for manufacturing), we may expect the boost for domestic manufacturing to continue (a slight turnaround in seasonally adjusted GUS business tendency indicators for June).

Decent output was accompanied by a sharp rise in producer prices. Given the behavior of the EURPLN rate (a fundamental change of the regime owing to global risk aversion is very likely) and firms' price expectations, the development is not of one-off origin and will continue in coming months. The possibility of pass-through from PPI to CPI is rising and may coincide with fading base effects, ultimately leading CPI substantially higher (2.8% in the year end and farther in 2011).

Retail sales. May brought an acceleration in consumer spending (retail sales +4.3% y/y vs -1.6% in April), however, it stood at odds with business tendency indicators (possibly lagging in this case) and – more importantly – occurred contrary to the further negative blow to VAT revenues (which seemed to beautifully corroborate our lower sales forecast…). The composition of spending suggests that not only there is a rebound after weaker April, but also that the process of wealth restoration has probably began (although we expect it to take-off in full-throttle in the summer months). At this stage we do not see any significant risk which could spoil the ongoing recovery in private consumption; tightening labor market seems to be the major driver on this field.

MPC decision. Current macro data may prove some MPC members that economic recovery is on its way. The constellation of data and recent more hawkish comments from some of the MPC members (Zielinska-Glebocka with her 50bps corrective hike in Autumn and Glapinski sticking to the scenario of 50bps hike in the year end) may then pose a minor risk of bias change at the looming MPC meeting (next Wednesday). On the one hand there is probably even higher projection (especially monetary-policy relevant 2012) and on the other the corrective nature of hikes proposed by some rate-setters (in such a scenario the change of bias would have been a non-intended sign of cycle of monetary tightening which seems hardly acceptable for the MPC at the moment) and ongoing risks to the economy from the spillover of debt problems and domestic fiscal position.

Elections. Komorowski 41,54%, Kaczynski 36,46%, Napieralski 13,68%. Contrary to some biased polls stipulating easy Komorowski victory, first round of elections was a surprise. The most probable theory explaining the final results suggests the extra votes gained by Napieralski are those discouraged by dull Komorowski presidential campaign and his over-reliance on Tusk. Although we think that Komorowski victory in the second round is more or less secured right now because it will be much easier for him to win leftist votes than for Kaczynski (criticizing the left at all times), there were no fresh public opinion polls (and given the recent blow, the advantage of Komorowski will have to be really high in order to be claimed safe) to corroborate such a scenario and there will be some uncertainty, especially on the back of recent Rostowski comments suggesting that the win of Kaczynski would be disastrous for the state of public finance. Just a small incentive for voters? It is hardly imaginable that prospective Komorowski supporters will pay any attention to such a reasoning, though. It looks like a unnecessary stress for bonds markets, especially in the current market regime.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.0	4.2
Inflation rate (%, average)	2.4	4.3	3.5	2.6	2.9
Current account (% of GDP, average)	-4.5	-5.3	-1.6	-2.7	-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	3.75	5.00

Indicator	2009		2010			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	1.7	3.1	3.0	2.3	3.1	3.9
Inflation rate (%, average)	3.5	3.3	3.0	2.1	2.2	2.8
NBP repo rate (end-of-quarter)	3.50	3.50	3.50	3.5	3.5	3.75

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

Fixed Income

The storm.

Last week we had finally some volatility on the FI market. The move started after much higher than expected PPI and Industrial Output. Initial reaction took 6x9 at 4.19 as the high and 5y to 5.20 (20 and 15 bp up respectively). After presidential election results, which showed much smaller difference between candidates than polls, market started to sell bonds, but even with information on unfixing the Yuan and EURPLN at 4.01 couldn't help bond market. PS0415 is actually in downtrend marking 6 straight day in a row with lower price on the closing fixing (PS0415 is down some 110 cents in week). Switch auction came with low price and reasonably small amount of fresh bonds, but even this made market to drift lower in prices. We started to see unwinds of ASW positions as PS0415 cheapened some 10bp (sic!).

Generally it looks the market is in pretty bad shape, especially on the bond side. Comments from Minister of Finance Rostowski are certainly adding fuel to the fire (as the coming election result is far from being clear and positioning of investors is rather heavy). Economic figures which market has been neglecting for sometime are clearly pointing towards higher CPI pressure on the horizon (wages, employment, PPI) and dynamics of EURPLN is definitely not helping to rebalance the economy at the moment. So far the bond market has been hit, but we are starting to expect MPC to have a more hawkish rhetoric once they will see inflation projection and influence of exchange rate on PPI and CPI respectively. Hardly to neglect is the fact of proper risk premium, and for us it clearly starts to look as if Poland would be in need to rise rates in order to restore one. All in all, we expect the rise of yields to continue. 5Y sector is to reflect general gloomy outlook pretty soon. More restrictive monetary policy may exert upward pressure on short-rates (higher FRA rates). Poland is deconverging, and so will monetary policy. We have a feeling the storm has just started.

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	6/28/2010	-	3.987%	6/21/2010
2Y T-bond OK0712	7/7/2010	-	4.675%	6/2/2010
5Y T-bond PS0415	7/14/2010	-	5.156%	5/12/2010
10Y T-bond DS1020	7/21/2010	-	5.790%	6/16/2010
20Y T-bond WS0429	7/21/2010	-	6.170%	9/23/2009

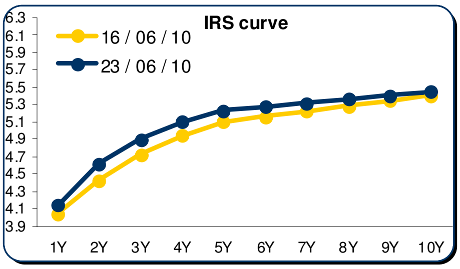
Money Market

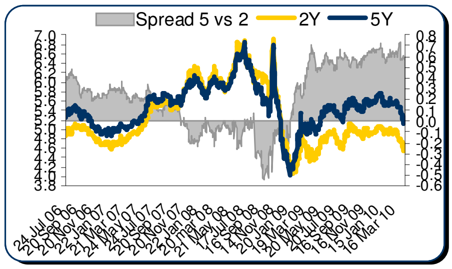
Shortest rates stabilized

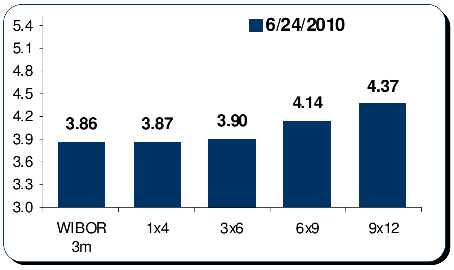
Real economy data quite surprising

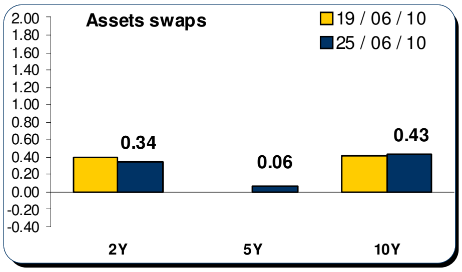
Liquidity was not a problem this week. Growing surplus, stable rates, we think its about time to get used to the new environment (stability of the polonia around the main rate – one of the monetary policy goals, which might be finally achieved? There is a probability that should be definitely considered). If we sum up this conclusion with the last week's figures, no wonder that ois curve went significantly up. Next step would be to push it even higher if one believes in above scenario. Speaking of figures: industrial output 14% vs 8.1% expected, retail sales 4.3 vs 3.1% expected, wages 4.8 vs 3.8% expected. Bearish for interest rates quite well justified.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty boxed in range

Although this week Zloty has lost 2.5% since Monday's open at 4.0150, bigger picture remains the same, since mid-May we trade 4.04-4.20 range. Last 4.20 top was followed by mentioned 4.0150 bottom (market euphoria, on news of bigger CNY flexibility) and then EURPLN rate has rebound to the mid of range (4.12). Zloty is still a hostage to the global sentiment, and the impact of ongoing presidential elections is limited (at least for the time being). Correlation of EURPLN with EURUSD cross has lowered to -0.35 %, but with EURJPY increased to -0.85% .

Implied volatility higher

Difference between Monday's curve (4.0150) and Thursday's one (4.12) is the difference of the short end, 1M EURPLN ATM 12.25% (mid) against to 13.75% (mid), whilst long end was traded steady at 12.5% mid. Whole move was more supported by underling higher levels than realized volatility which according to relatively stable trend amounted to 8%. Weaker Zloty was also reflected in smile change - 3M 25D EURPLN RR from 3.25 to 3.75. As an effect of lower correlation with EURUSD cross, EURPLN vs USDPLN currency spread is traded, despite higher spot, at similar, 8.5 level.

Short-term forecasts:

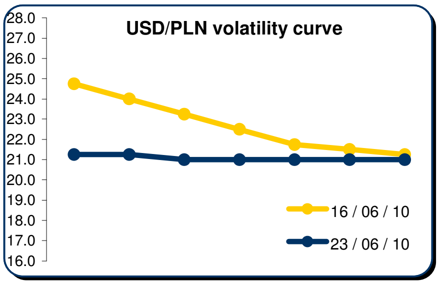
SPOT
Main supports / resistances:
EUR/PLN: 4.0400 / 4.2000
USD/PLN: 3.2400 / 3.4000

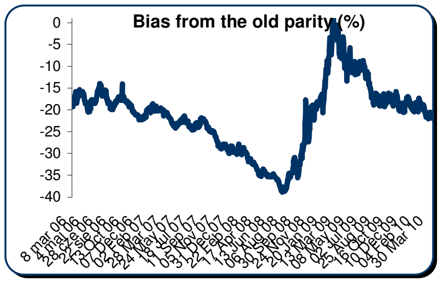
Zloty seems to be driven by external environment's weakness. We remain optimists concerning the future zloty strength.

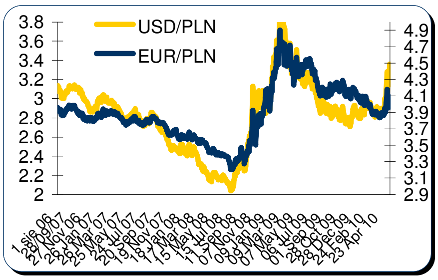
OPTIONS

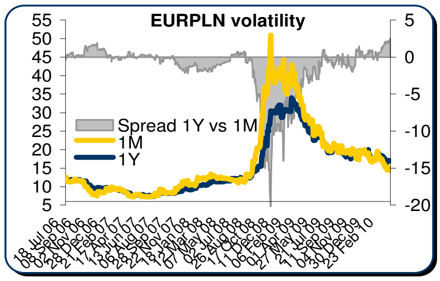
Influence of periods of low realized volatility is netted out by days of boosted one. Sentiment fluctuations provides enough bargains to look for higher gamma. However, it has to be taken into account that the historical volatility is now heading lower. From the Vega point of view it is possible to see some downward potential, although as soon as situation calm down, the tendency may be somehow (temporarily?) disturbed.

FX CHARTS









MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M FXSW	3M WIBOR	6M FXSW	6M WIBOR	1Y FXSW	1Y WIBOR
17/06/10	3.71%	3.85%	3.90%	3.91%	4.14%	4.14%
18/06/10	3.70%	3.85%	3.87%	3.89%	4.13%	6.59%
21/06/10	3.71%	3.85%	3.87%	6.49%	4.15%	4.14%
22/06/10	3.78%	3.86%	3.90%	3.89%	4.15%	4.14%
23/06/10	3.79%	3.86%	3.86%	3.89%	4.15%	4.14%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
17/06/10	3.87%	3.88%	4.00%	4.20%	4.19%
18/06/10	3.87%	3.88%	4.00%	4.19%	4.21%
21/06/10	3.86%	3.88%	4.01%	4.20%	4.21%
22/06/10	3.88%	3.90%	4.11%	4.31%	4.30%
23/06/10	3.87%	3.89%	4.10%	4.34%	4.33%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y WIBOR	1Y TB	2Y IRS	2Y OK0112	5Y IRS	5Y PS0511	10Y IRS	10Y DS1017
17/06/10	4.14%	3.96%	4.45%	4.35%	5.13%	5.09%	5.40%	5.79%
18/06/10	6.59%	3.99%	4.55%	4.45%	5.20%	5.20%	5.41%	5.83%
21/06/10	4.14%	4.00%	4.58%	4.44%	5.19%	5.20%	5.43%	5.83%
22/06/10	4.14%	4.01%	4.62%	4.49%	5.23%	5.24%	5.43%	5.87%
23/06/10	4.14%	4.00%	4.62%	4.48%	5.23%	5.29%	5.45%	5.88%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/06/21	11/06/21	96.125	3.99%	1000	1871	944
OK0712	10/04/07	12/07/25	89.301	4.54%	3000	6726	2999
PS0415	09/04/21	15/04/25	102.209	4.99%	3000	6623	3000
DS1019	10/06/16	19/04/25	95.807	5.79%	3000	2965	2430

FX VOLATILITY

date	USD/PLN 0-delta stradle 1M	3M	6M	1Y	25-delta RR 1M	1Y	25-delta FLY 1M	1Y
17/06/10	21.50	21.25	21.15	21.00	5.25	6.40	0.75	0.95
18/06/10	21.25	21.00	21.00	21.00	5.25	6.40	0.75	0.95
21/06/10	20.75	20.75	20.75	20.75	4.50	5.70	0.75	0.95
22/06/10	21.25	21.25	21.25	21.00	4.50	5.70	0.75	0.95
23/06/10	21.25	21.25	21.00	21.00	4.50	5.70	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
17/06/10	3.3095	4.0811	-13.17%
18/06/10	3.2864	4.0732	-10.75%
21/06/10	3.2463	4.0300	-11.13%
22/06/10	3.2912	4.0535	-11.75%
23/06/10	3.3054	4.0587	-11.87%

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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