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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of July 8th 2010 to July 15th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
CPI Inflation y/y	Jul 13	Jun	**2.1%**	2.1%	2.2%	Relative stable food and fuel prices (the former much higher than seasonal pattern); gas tariffs hikes of rather minor importance. MF estimate at 2.1%. Owing to the MF methodology there is a risk of 2.2% reading.
C/A balance EUR	Jul 13	May	**+120mln**	-280mln	-424mln	A turn into positive territory mainly on EU transfers but also lower trade deficit added a little bit. Exports affected by solid industrial output, wholesales trade affecting imports.
M3 Supply y/y	Jul 14	Jun	**7.9%**	7.8%	7.6%	Lower growth of household and corporate deposits.

In Focus / Macroeconomics

2011 budget macro-assumptions.

Information agencies quote that the next year's budget bill is going to be based on 3.5% GDP growth and 2.3% inflation; nominal wage growth is expected at 3.7%, whereas the level of employment is likely to increase by 1.9%. As for the composition of GDP growth, there is higher fixed business investment contribution than consumption (quite reasonable assumption, stemming mainly from boosted absorption of EU funds). PLN is expected to strengthen gradually in the environment of slowly rising NBP rates. The assumptions do not diverge much from the market consensus. Hence, they can be fully regarded as conservative, perfectly in line with the gist of budgeting process.

As for the qualitative details, expenditures are going to be based on spending rule which limits the growth of elastic expenditures and the new bill-determined expenditures to the level of inflation plus 1pp. There are also several tools aimed at limiting the government consumption: public wages freeze, boosting effectiveness in administration, long-term planning principle and more efficient allocation of cash reserves circulating within the public sector. The tools (together with the income side determined mostly by macroeconomic assumptions – so far there are no systemic changes) are supposed to (owing to the sources cited by the agencies) bring central budget deficit to PLN 40bn next year (the public sector deficit was not mentioned). The details are likely to be published along with the long-term financial plan for the state, due to be released at the end of July. It may be a major event as there are quite high expectations on the path of deficit reduction in the environment of the strict commitments among EMU countries and Poland's regional peers, especially taking account of the new political geography in Poland after presidential elections.

In our opinion, high social support for opposition party (reflected in relatively high Kaczynski result), together with looming local and parliamentary elections, may limit the room for maneuver in public finances in the next two years. Investors should pay then more attention to the public sector deficit and the borrowing needs of this sector (note that the Ministry of Finance admits it has no control over the local authorities, and this – as always – is important determinant for the whole public sector deficit). We think that the scope for improvement on this fields is at least limited (borrowing needs, on higher redemptions and coupon payments and substantially lower privatization flows are likely to be even higher than in 2010) and this fact may visibly contrast with the developments within EMU and CEE countries. Such a scenario may induce the risk premiums over the Polish debt to rise. It is hard to pin down the moment when it all begins, though. Positive sentiment is dominant at the moment, supported by the inflow of foreign capital (at the center stage there is still the outperforming real sphere, seemingly positive political developments and doubts on the Fast monetary tightening conducted by the government-supportive MPC). At the moment sound information policy of the Ministry of Finance may even strengthen the ongoing tendency.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.1	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	-1.8	-2.9
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	2.7	3.2	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

Nothing really new.

Last week was rather interesting on the FI. Initial negative reaction after higher than expected support for Kaczynski in presidential elections started to fade. Market saw yields in 5y and 10y bonds as an opportunity to reload on long positions and we have seen decent buying from both local and international community. Curve had flattened by some 10bp. especially in the 2y5y sector coming down to 52bp on Thursday. Results of elections supported market and rally continued. The highlight of the week was 2y bond auction (OK1012) which brought very good demand and the very good price (average price from the tender came above secondary market offer). All in all market is 100 cents higher in 5y bonds within 2 weeks time and 5y is approaching 5% barrier yet again.

We are entering real holiday period in the market. Data wise we don't expect anything significant to happen, maybe apart from a touch higher CPI reading and PPI reading. But with no MPC meeting anytime soon these factors can play a minor role. On the fiscal side we had a chance to see assumptions to the budget draft, but they give very little inside. Deficit is planed to come at 40 bio PLN or less, but for market crucial thing should be the borrowing needs and the fiscal tightening in terms of the whole public sector, but this data is going to reveled not earlier than in September. We have to admit that market has lost a lot of its dynamics in terms of yields going higher and constant inflow to the EM funds can prove to be a decisive factor in the short term. Nevertheless, we see position in the market as rather heavy and while "illusion" lower supply in the 3Q is working and Komorowski's win renewed hopes for fiscal consolidation, we remain skeptical. We don't see any reforms, that would change fiscal perspective happening ahead of double elections (municipal this year and parliamentary next year). We also see policy mix being very stimulating (real rates at 0.5%, 3 year running with deficit of around 6% of GDP or higher, MCI approaching highs). Therefore we currently stick to our earlier plans.

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	7/5/2010	-	4.072%	6/28/2010
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

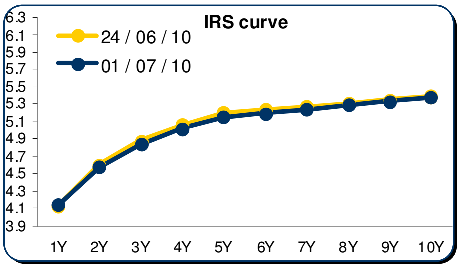
Money Market

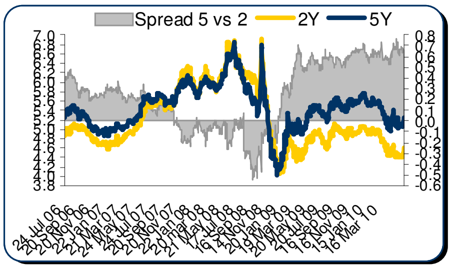
Summer slowdown

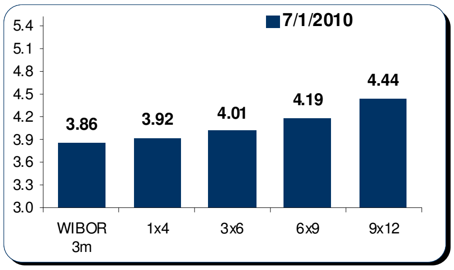
Next MPC meeting in 1.5 month

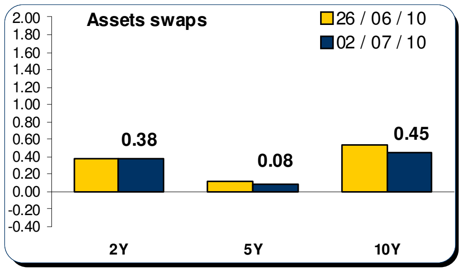
Summer time fully blown. Not too much action at all. Cost of carry stable just below the 3%, probably it will stay like this for another week. The MPC meeting without any decision and 1.5 of the month break ahead. T-bills stable at weekly tender with an average yield of 4.08%. FinMin's CPI projection also in line with expectations at 2.1%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty boxed in range

EURPLN on Monday has opened below previous week's 4.12 low and (supported by election result) has continued trading on stronger side, touching 4.07 on Thursday. Although global risky assets have improved their performance, range of PLN strengthening seems to be limited. We see summer market as the reason of lower interests volume. Nevertheless correlation with DJ (-0.6), EURUSD (-0.8), EURJPY (-0.7) benchmarks remains at high levels. Lower tops, higher bottoms? As a bigger picture we have to mention about series of tops: 4.240, 4.20, 4.18, and bottoms: 3.95, 4.01, 4.08 (?). It simply narrows.

Implied volatility lower

This week numbers are: 10.1% (Thu-Thu) and 6.4% (Mon-Thu) realized volatilities (EUR/PLN). Stronger Zloty and lower realized volatility, had obviously pressured down implied volatility curve. But supported even by 1M close-close realized (about 10%) impact was limited. Monday's opening curve pointed by 1M ATM 14.15, 3M 14.0 and 1Y 13.5 has developed into inverted/flattish one: 1M 12.8, 3M 13.0 and 1Y 13.0. Implied curve simply still prices in decent chance of PLN weakening. Smile (3M 25D EURPLN RR benchmark), despite lower spot has not reacted noticeably. EURPLN vs USDPLN currency spread is traded (with lower EURUSD vols) lower, at 8.25, level.

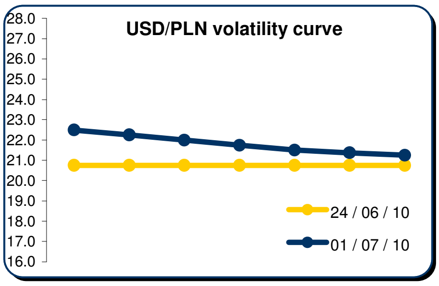
Short-term forecasts:

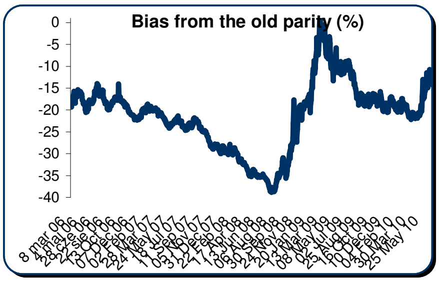
SPOT
Main supports / resistances:
EUR/PLN: 4.0400 / 4.2000
USD/PLN: 3.3500 / 3.5000

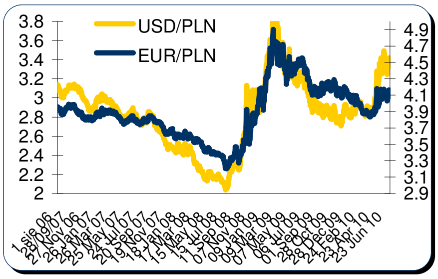
The wider 4.00/4.20 range still intact. We see a possibility for the zloty to appreciate towards 4.05. In case of a rebound 4.12 and 4.10 are important levels.

OPTIONS
Number of days with realized vols above implied has decreased significantly. As an effect, we would see a possibility to make use of gamma spikes, although we stay cautious as for the longer-term downward movement. 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


USD/PLN volatility curve
28.0
27.0
26.0
25.0
24.0
23.0
22.0
21.0
20.0
19.0
18.0
17.0
16.0
24 / 06 / 10
01 / 07 / 10


Bias from the old parity (%)
0
-5
-10
-15
-20
-25
-30
-35
-40


USD/PLN
EUR/PLN
3.8
3.6
3.4
3.2
3
2.8
2.6
2.4
2.2
2
4.9
4.7
4.5
4.3
4.1
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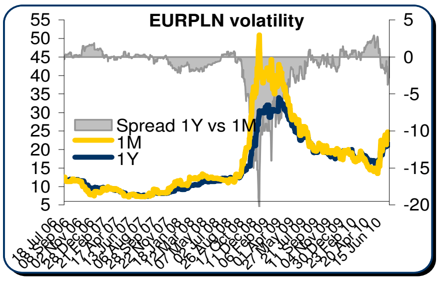
3.7
3.5
3.3
3.1
2.9


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
55
50
45
40
35
30
25
20
15
10
5
5
0
-5
-10
-15
-20

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
25/06/10	3.72%	3.85%	3.89%	3.89%	4.10%	4.14%
28/06/10	3.72%	3.85%	3.87%	3.89%	4.10%	6.59%
29/06/10	3.77%	3.85%	3.87%	6.49%	4.13%	4.14%
30/06/10	3.75%	3.86%	3.90%	3.89%	4.32%	4.15%
01/07/10	3.78%	3.86%	3.91%	3.90%	4.16%	4.15%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
25/06/10	3.86%	3.90%	4.14%	4.39%	4.36%
28/06/10	3.87%	3.91%	4.15%	4.38%	4.37%
29/06/10	3.87%	3.90%	4.14%	4.37%	4.35%
30/06/10	3.87%	3.90%	4.14%	4.37%	4.36%
01/07/10	3.88%	3.92%	4.17%	4.41%	4.37%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IRS	DS1017
25/06/10	4.14%	4.06%	4.59%	4.52%	5.20%	5.32%	5.40%	5.93%
28/06/10	6.59%	4.10%	4.61%	4.52%	5.21%	5.32%	5.42%	5.93%
29/06/10	4.14%	4.11%	4.61%	4.52%	5.18%	5.28%	5.40%	5.91%
30/06/10	4.15%	4.13%	4.58%	4.52%	5.15%	5.23%	5.38%	5.83%
01/07/10	4.15%	4.13%	4.58%	4.52%	5.15%	5.23%	5.38%	5.83%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/06/28	11/06/28	96.045	4.07%	1800	2788	1442
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

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
25/06/10	22.25	22.00	21.75	21.50	4.75	5.90	0.75	0.95
28/06/10	22.25	22.00	21.75	21.50	4.75	6.10	0.75	0.95
29/06/10	23.00	22.25	22.00	22.00	5.00	6.10	0.75	0.95
30/06/10	22.85	22.50	22.25	22.00	5.00	6.00	0.75	0.95
01/07/10	22.85	22.50	22.25	22.00	5.00	6.00	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
25/06/10	3.3643	4.1405	-13.50%
28/06/10	3.3270	4.1148	-13.58%
29/06/10	3.4157	4.1649	-14.09%
30/06/10	3.3946	4.1458	-13.87%
01/07/10	3.3773	4.1529	-14.22%

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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