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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 November 19th 2010 to November 26th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Industrial output	Nov 19	Oct	**10.0%**	9.7%	11.8%	One working day less on annual basis and rumors on some automotive factory temporary closings (Fiat). Strong PMI supports strong momentum.
Producer prices	Nov 19	Oct	**4.2%**	4.0%	4.3%	Substantial rises in copper, oil and gold prices offset by PLN appreciation.
Core Inflation	Nov 22	Oct	**1.2%**	1.2%	1.2%	4 months of stability. No signs of core inflationary pressures present in monthly data. Core is set to drift higher, but so far only slowly.
MPC decision	Nov 23	-	**3.50%**	3.50%	3.50%	Bratkowski sees no necessity to hike already in November….Status quo (no hike) supported by Belka. It seems MPC may allow for more zloty appreciation as a substitute of rate hikes.
Retail sales	Nov 25	Oct	**7.9%**	7.9%	8.6%	Some flattening of auto sales (substitution effect caused by announced VAT-related tax reliefs for enterprises), other durables seem to start forming new upward trends (although such a reasoning may be misleading as substitution effects rule). Retail may soften a bit as 2011 begins.

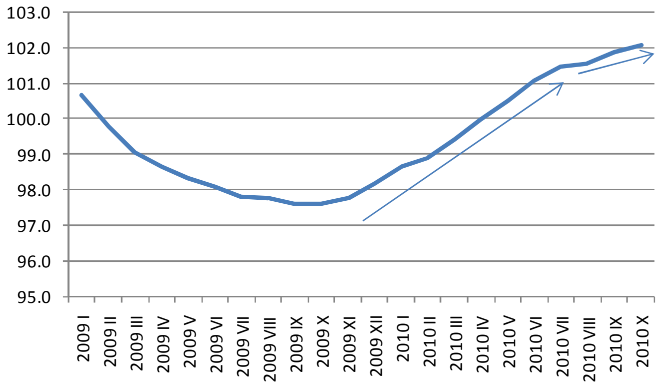
In Focus / Macroeconomics

Inflation trending higher, labor market on the mend

CPI came out identical to our call of 2.8% y/y (FinMin estimate 2.9%) and market consensus and officially breached the NBP inflation target (2.5%). Among the main drivers there are food prices (+1.1% m/m), wearing apparel (seasonal +1.7% m/m), gas (+1.0% on energy prices) and education (seasonal +0.6%). As for the downward, monthly moves, there is a fall in recreation and culture (-0.6% m/m) and telecommunications (-0.1% m/m – we think this is a one-off effect of lower Internet prices quoted by the largest provider TPSA). So far, the rise of prices seems to be of supply-origin and they do not pass through to core measures – we estimate that core inflation for the fourth consecutive month has stayed at 1.2% y/y.

We believe the impact of supply shock (agriculture commodities) is set to slowly fade in coming months (classic hump-shaped response of CPI to such a shock, “flatter” than in 2007). However, CPI will be driven upwards by base effects and various one-off factors taking toll at the beginning of 2011 (VAT hikes, state-regulated price hikes). In November, inflation is likely to hit 2.9%-3.0% and speed up to 3.1-3.2 in the year end. We think that strong labor market (some on that below) constitutes a strong inflationary factor within monetary policy horizon which may be also able to carry over some of current high inflation owing to mounting inflation expectations (to be present in wage negotiations soon).

Employment in enterprise sector hit 2.1 y/y. Although we see some moderation in annual growth rate (see the graph), we would not describe it as an anomaly, but usual situation after the strong rebound during the very beginning of the upswing phase; moderation seems also normal as there is lots of uncertainty over the global economy. We think that employment is set to rise further in coming months (some business-cycle sensitive manufacturing sections have recently started to hire again). A more pronounced acceleration can be expected within 2-3 quarters as labor productivity is topping (2007-2009 average 2.5% y/y, 2009-now 7.9% y/y) and enterprises cannot exploit labor force in such a manner for long.



The ultimate resolution of mounting labor market pressures – apart from rises in employment – will be the growth of wages. Although recently the wage pressures seem mute at the aggregate level (wage growth in October hit 3.9% after 3.8% a month ago), there is growing evidence of wage acceleration in manufacturing (running already above 6% y/y). Further growth of wages will be supported (apart from the cyclical factors) by the ongoing fiscal stimulation and infrastructure investment.

Although inflation reading seemed to be MPC neutral (the majority within MPC shares the view that so far the rise in inflation is of supply origin and MPC reaction may lead to an unnecessary contraction of output), labor market data (along with the recent trend in wages and employment) increase the balance of risks to inflation in the medium term. “Minutes” suggest the MPC is focused on global issues and would not accept the excessive zloty appreciation (although MPC may trade some of the “natural” appreciation for rate hikes, at least for some time). As soon as inflation expectations are anchored (owing to their adaptive nature, we may see a higher reading in November, but the MPC is unlikely to act solely on that basis, as it once proved misleading), rate-setters would like to focus on the real sphere and wait for the broader picture (Q3 GDP reading is published one week after November MPC decision). Therefore, we would not bet on a

November hike, but still it may be a close call as the data inflow will not allow hike expectations to fade. We think the first hike is likely in Q1 2011.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.6	4.2
Inflation rate (%, average)	2.4	4.3	3.5	2.8	3.5
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	**3.50**	4.50

Indicator	2009		2010			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	1.7	3.1	3.0	3.5	3.9	4.0
Inflation rate (%, average)	3.5	3.3	3.0	2.1	2.6	2.8
NBP repo rate (end-of-quarter)	3.50	3.50	3.50	3.5	3.5	**3.50**

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

Fixed Income

No hikes - steeper curve but for how long ?

Market started this week quite stable, fluctuating around recent highs. Monday's publication of CPI data, even though slightly lower than previous MinFin's estimate (2.8% vs. 2.9% y/y) didn't cause much change in yields. More impact on the market came from surprisingly dovish comments from Bratkowski, who withheld his support for 50bp hike of rates and also called November's move as 'unlikely'. As a result curve moved down rapidly by some 10-12bp in the front end (2y traded lowest at 4.78%). Longer maturities also gained some 5bp as the curve steepened further. Wedensday's 10Y bond auction attracted close to 5bio demand and MinFin successfully placed 3bio at 5.77-79% level. Despite relatively good auction, long end of the curve remained under pressure, following core markets, and curve steepened further (some 15bp over the week, 2Y-10Y reached 54bp). Current levels seem to create some value to receive. Macro data don't support monetary policy tightening, next week's hike seems unlikely, which would mean first 25bp hike in 1Q2011, scale of recent sell-off/steepening looks overdone. We see best value in 1y1y forward and PolGB's in 10y sector.

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	11/22/2010	-	4.056%	10/25/2010
2Y T-bond OK1013	12/1/2010	-	4.595%	10/6/2010
5Y T-bond PS0416	12/3/2010	-	5.137%	10/13/2010
10Y T-bond DS1020	-	-	5.772%	11/17/2010
20Y T-bond WS0429	-	-	6.170%	9/15/2010

Money Market

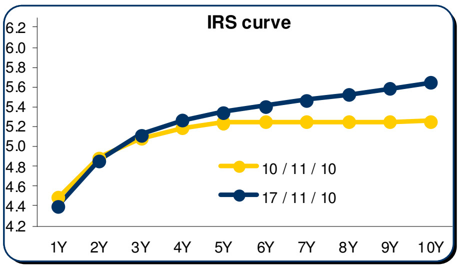
Liquidity stable

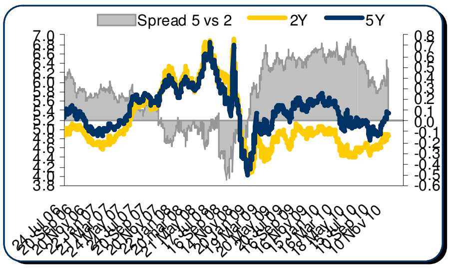
Easy week as far as the liquidity of the system is concerned. With the cash surplus of around 2 billion pln cost of carry was stable and nearby the level of 3%. Today's OMO will show the direction of the short cash for the week ahead.

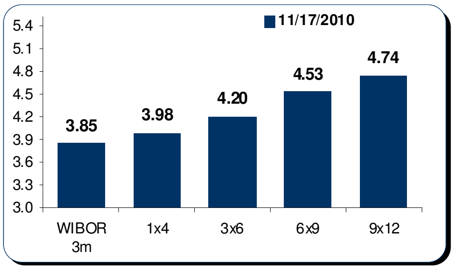
Mr Bratkowski triggered change of the sentiment

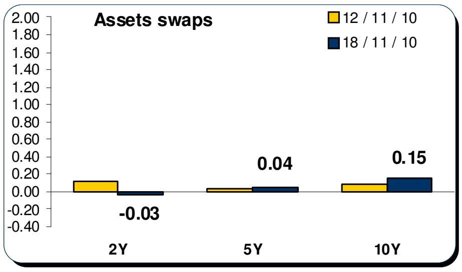
CPI at 2.8% (2.9% forecasted by the MinFin) and most of all surprisingly soft comment of the hawk Bratkowski, changed the sentiment at least for a while. MM derivatives curves dropped by 10-20 bps depending on the tenor, and less and less players expect the monetary tightening this month. If they are right and no hike will be made indeed, there is still plenty of room for the tenors up to 1Y to deteriorate further.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in range

Albeit, we have touched recently 3.8770 (10 Nov), the bigger picture hasn't changed, Zloty is trapped in range. Range for this week was bounded by 3.92 and 3.97, range from end-of-July since now is 3.8770-4.0280 (15 big figures). Neither Fed QE 2.0 nor Ireland debt problems has provoked interest strong enough to break boundaries. What is able to provoke such a move then? Enea IPO back in the picture, as Kulczyk owned company losses its exclusivity in negotiations.

Curve untouched

Despite narrow range, active trading of its boundaries has elevated realized volatility to about 10%. This fact plus varying global sentiment supports relatively high curve, 1M 10.2, 3M 11.1, 1Y 12.2, same as in previous week. Untouched also has stayed RRs curve where 3M 25D benchmark was traded at 2.6. Noticeable change we might observe on USDPLN vs EURPLN spread where 3M spread has slipped from 8.25 to 7.85.

Short-term forecasts:

SPOT

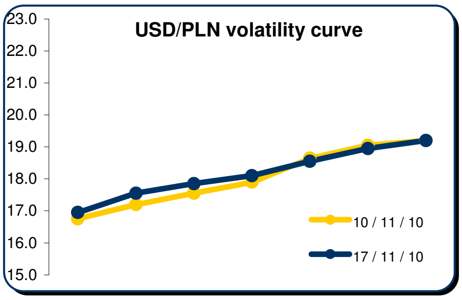
Main supports / resistances:
EUR/PLN: 3.8800 / 3.9800
USD/PLN: 2.7900. / 2.9000

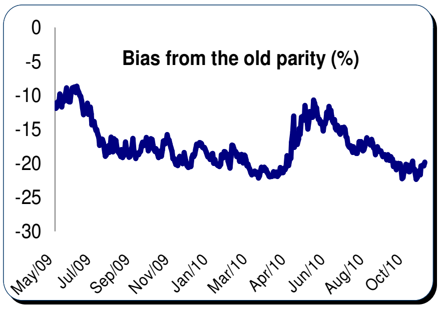
Ireland debt problems, factor which drives EM at the moment, seems to have low momentum. Low enough that we see probability of breaking 4.00 as unlikely. PLN, supported by possible privatization inflows but threaten by budget deficit, is most likely to stay in present range slightly skewed to the stronger side. Important levels stay untouched: sell 3.98, add at 4.00, S/L at 4.03 and P/T at 3.88.

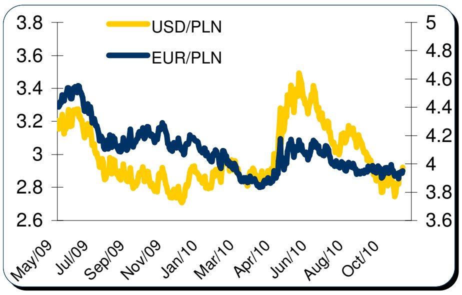
OPTIONS

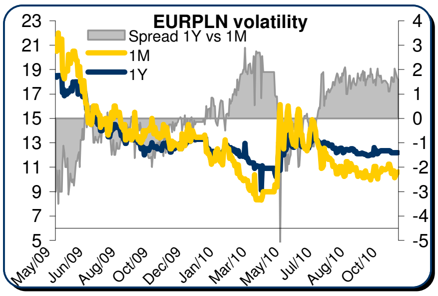
The short gamma position is performing well, we would like to stick to this idea. We also prefer to be neutral/ slightly short Vega.

FX CHARTS


USD/PLN volatility curve
10 / 11 / 10
17 / 11 / 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 FXSW	3M WIBOR	6M FXSW	6M WIBOR	1Y FXSW	1Y WIBOR
10/11/10	3.83%	3.86%	3.96%	3.95%	4.18%	4.17%
12/11/10	3.75%	3.86%	4.01%	3.95%	4.21%	6.59%
15/11/10	3.77%	3.86%	3.95%	6.49%	4.20%	4.17%
16/11/10	3.73%	3.85%	3.96%	6.49%	4.17%	4.17%
17/11/10	3.77%	3.85%	3.94%	3.95%	4.15%	4.17%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
10/11/10	4.08%	4.31%	4.63%	4.84%	4.79%
12/11/10	4.06%	4.29%	4.60%	4.81%	4.76%
15/11/10	4.07%	4.30%	4.63%	4.84%	4.78%
16/11/10	4.07%	4.31%	4.64%	4.85%	4.81%
17/11/10	4.08%	4.30%	4.64%	4.85%	4.83%

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
10/11/10	4.17%	4.18%	4.89%	4.89%	5.25%	5.35%	5.26%	5.70%
12/11/10	6.59%	4.16%	4.77%	4.89%	5.34%	5.38%	5.65%	5.73%
15/11/10	4.17%	4.14%	4.83%	4.88%	5.34%	5.36%	5.65%	5.74%
16/11/10	4.17%	4.13%	4.85%	4.80%	5.37%	5.36%	5.66%	5.74%
17/11/10	4.17%	4.03%	4.86%	4.83%	5.35%	5.38%	5.65%	5.81%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/09/27	11/09/27	96.189	3.92%	600	1150	580
OK0113	10/10/06	13/01/26	90.178	4.60%	3000	7568	3000
PS0416	10/10/13	16/04/25	99.300	5.14%	3000	3414	2491
DS1020	10/09/15	19/04/25	98.383	5.46%	3000	8953	3000

FX VOLATILITY

date	USD/PLN 0-delta stradle 1M	3M	6M	1Y	25-delta RR 1M	1Y	25-delta FLY 1M	1Y
10/11/10	17.20	17.90	18.65	19.20	2.50	4.40	0.65	0.88
12/11/10	17.60	18.10	18.60	19.20	2.55	4.50	0.65	0.87
15/11/10	17.45	18.05	18.55	19.20	2.70	4.25	0.65	0.87
16/11/10	17.45	18.10	18.55	19.20	2.70	4.25	0.65	0.87
17/11/10	17.55	18.10	18.55	19.20	2.70	4.25	0.65	0.87

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
10/11/10	2.8220	3.8964	-21.6%
12/11/10	2.8865	3.9377	-20.4%
15/11/10	2.8915	3.9430	-20.3%
16/11/10	2.8937	3.9348	-20.3%
17/11/10	2.9217	3.9510	-19.8%

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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