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FINANCIAL MARKETS DEPARTMENT

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WARSAW, JANUARY 7, 2011

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of January 7th 2011 to January 14th 2011

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
CPI Inflation y/y	Jan 13	Dec	**3.2%**	3.1%	2.7%	Food prices at +0.8-1.1% m/m supported by higher fuel prices (+5% m/m) allow inflation to rise towards 3.2%. MF conservative forecast at 3.1%.
C/A balance EUR	Jan 13	Dec	**-1752mln**	-1350mln	-1155mln	Exports 11105mln EUR, Imports 12016 mln EUR. Minor changes of industrial output, durable goods in particular, rising auto sales. Significant negative transfers balance (-557mln EUR), almost stable income and services account.
M3 Supply y/y	Jan 14	Dec	**8.5%**	8.6%	9.0%	Trend steepening.

In Focus / Macroeconomics

Record high PMI, CPI trending higher…hawkish MPC member and governor Belka himself

Manufacturing PMI enjoyed fifth consecutive month of growth and reached 56.3pts. – the highest level since May 2004 and third highest in the whole series. Although indices concerning output and new orders leveled off a bit, new export orders component shot up, reflecting trade connections with the German economy. We remain positive on Polish manufacturing – German demand as a driving force will stay in place, backed up additionally by accelerating domestic demand.

As for the nominal sphere, the Ministry of Finance (MF) announced that CPI inflation had rose in December to 3.1% from previously reported 2.7%. The core driver of CPI are fuel prices (4-5% growth on monthly basis); surprisingly the MF claims that food prices remained stable. Although such a claim stands in sharp contrast with our econometric model (food prices at +0.5-0.7% m/m) or wholesale data (+1.1% - sharp rises in vegetables), the Ministry has got exact data on prices for first two weeks of December. It is not unlikely that MF underestimates the growth of food prices (especially taking into account the usual conservative stance towards the forecast = flat food prices in the second part of the month), but to prove the forecast wrong one has to provide evidence that second part was characterized by rapid growth of food prices which is hard owing to scarce evidence being available during the Christmas season. Therefore we would rather lower our forecast to 3.2% citing the recent surprise in HICP flash inflation (seemingly food driven) as a possible upside risk factor.

Higher inflation reading encouraged MPC members to comment in a more hawkish note. Kazmierczak mentioned that current level of inflation is worrying and in case it is repeated in the forthcoming months MPC will raise interest rates. Glapinski is even more straightforward by claiming the rates should be raised already in January as there is more and more wage pressure in current CPI reading and it is going to only strengthen in coming months, not mentioning the effects commodity boom which we are in now. Crucial was the message delivered by Belka, though. He directly points towards monetary tightening as he sees rate hike as a mean to jump-start zloty appreciation process (he stressed the exchange rate channel is most effective in the Polish economy). However, the rate hike he refers to should mark a start of a cycle (so one-off corrective hike seems even more out of question now) and it should be delivered when financial markets are relatively calm, able to properly digest the message. The necessity to normalize rates stems also from the real sphere of the economy as Belka points out (which perfectly fits our baseline scenario) to the stability of Polish GDP growth and looming turnaround in investment activity.

It seem financial markets treat the January hike as a done deal right now. However, one should bear in mind the conditional character of the governor's statement (calm financial markets – the postulate which, in our opinion, has not been met yet) and the abrupt reaction of EURPLN which dived below 3.90 (equivalent of some 25bps tightening since the start of the year); the sustainability of the appreciation may be an important piece of information during the time of the decision (18-19 January). We think the probability of a first hike is still greater in March than January (60:40). As for the longer horizon we believe that the whole tightening cycle will be "flatter" than previous ones (75-100bp.) owing to the zloty appreciation which will imminently follow the first rate hike.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.8	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	-3.1	-3.8
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	4.2	4.5
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

Massive repricing in the front end. Can rates really get there?

New year started with significant repricing in the front of the yield curve. Move was caused by some relatively hawkish comments from Belka. Main points from the interview were that he's quite ready to begin tightening to 'unleash zloty's strenghtening potential' and also that market should be ready for a cycle of smaller steps, not for a adjustment in one-two bigger moves. Reaction to that was really strong. 2Y moved up by 20bp to 5.15%, also FRAs moved in similar, 20-25bp scale. What is curently priced in, is a hike this month, another in March, possibly in April. Basically it seems that the MPC would actually have to hike by 25bp on every or almost every meeting so that rates could actually reach levels implied by FRAs. That is really the scenario that we consider almost impossible to happen. Even though probability of January hike has increased dramatically over past week, it's still not an obvious call, especially considering that Belka's verbal intervention alone was enough to cause some PLN strenghtening. Anyway even if in case of a hike this month, the most likely scenario seems to be some 75bp in three steps in 1H2011, just to the moment, where CPI reaches it's peak (April-May). From that point it's hard to expect tightening to continue in same pace, and even harder to expect it to continue in 2012. But it does look like we are in the point where main market drivers are the positioning and the fact, that tightening is about to begin, which pushes rates higher somehow automatically. However flattening of the curve is the first symptom that something is changing here. Next step should be some revaluation of scenarios priced in the curve which would create some good receiving opportunity. For the time being, even though levels might seem attractive because of sharp move we've just observed, we'd rather be cautious to put on much risk on, however we definitely don't want to have pay position at current levels.

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	2/2/2010	-	4.056%	10/25/2010
2Y T-bond OK1013	1/5/2011	-	4.798%	12/1/2010
5Y T-bond PS0416	1/5/2011	-	5.137%	10/13/2010
10Y T-bond DS1020	1/12/2011	-	5.772%	11/17/2010
20Y T-bond WS0429	1/12/2011	-	6.170%	9/15/2010

Money Market

OMO intervention adds volatility by its timing

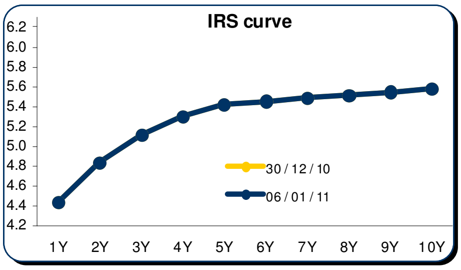
Mr Belka comment started substantial move north

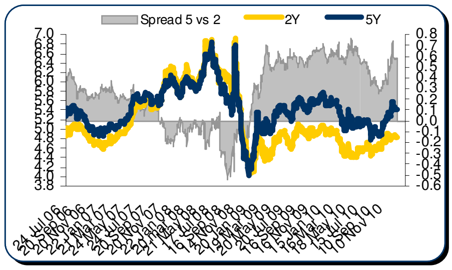
Hectic week behind with the OMO intervention for shortest rates and Mr Belka comments driving longer rates crazy.

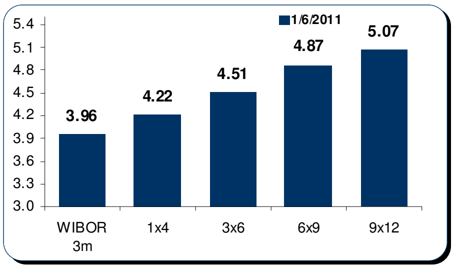
The first event was driven by the huge cash surplus left on the market due to the year break. Market bought 15 bln pln of 3-day money bills out of 18-billion on the offer. After OMO we saw 2 billion short cash in the system, nonetheless today regular OMO should bring things to normal. Intervention was quite logic and clear, however timing was unfortunate. The CB decided about additional auction 30-some minutes after regular time of announcing the OMO, then back it with comments that anytime is good enough. Well in our opinion its not, and in the worst case scenario can malfunction the interbank market (long positions waiting for OMO all day, short unable to get any financing in a reasonable timing). To sum up, again the central bank add huge volatility and uncertainty to the market with its hard to accept lack of appropriate communication. This makes our authorities exceptional in a globe scale.

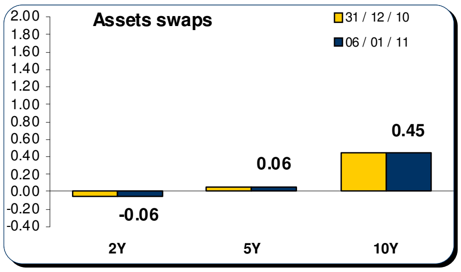
Mr Belka who was perceived by the market as a dove made a statement that suggested faster rates hikes. The curve moved 25 bps and the currency strengthen by 8 figures. Probably he has achieved what he wanted without hiking. We still see the biggest probability for the cycle to start in March or even April, therefore those levels look really attractive from this perspective to be sold (market curve discounts full 25 bps hike in January plus 100 bps more within a year).

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Since New Year's Day Złoty to EUR has gained about 3% marking 9 months low at 3.85. Finally, so eagerly highlighted, local strong fundaments combined with down option barriers and CB looking for stronger side of PLN have overweighted global fiscal fears and we have observed rush for PLN buying. Demand for Złoty remains at high level and in common market opinion we may expect further strengthening.

Volatility lower

Stronger Złoty but higher realized volatility (about 11%!) – this is present environment for implied market. What was reaction? Vega selling – 1M has stayed about 10 %, while 3M and 1Y were pushed lower to respectively 11.1 (11.4 last week) and 12.2 (12.5). Lower ATMs were followed by Riskies run – 3M has moved from 3.0 to 2.6, 1Y from 3.75 to 3.4.

The currency spread (USD/PLN versus EUR/PLN) driven by lowering USDPLN realized (15%) has been sold down to 7.8% (8.5 week ago).

Short-term forecasts:

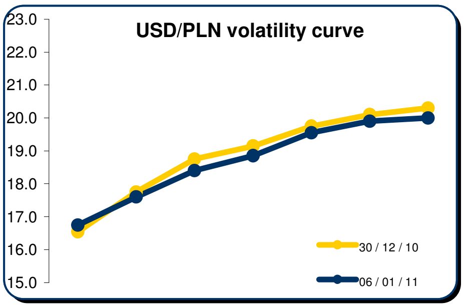
SPOT

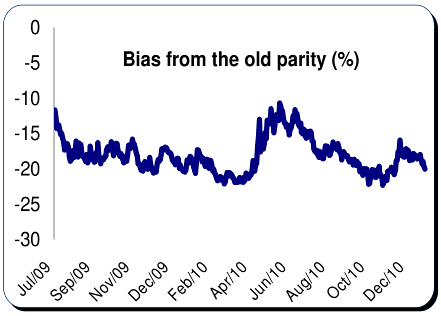
Main supports / resistances:
EUR/PLN: 3,8000 / 3.9800
USD/PLN: 2,8400 / 3.0600

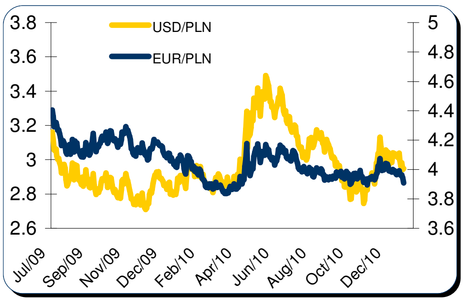
Although market looks bit oversold present enthusiasm makes decent impression. We look for selling upticks (3.96, S/L 4.01, P/T 3.80). Worth remembering is fact that local sentiment being stronger than opposite global one is as rare as white whale.

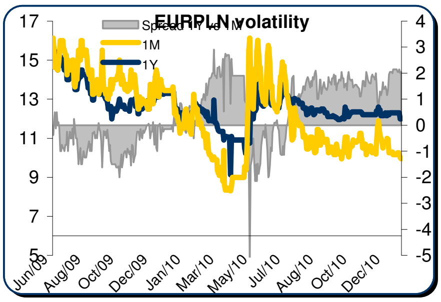
OPTIONS
Fair priced gamma, we have closed our shorts, and plan to be gamma neutral for a time being. Our focus shifts to longer term (above 6 months risk reversals and Vega), in our eyes we are getting to closer to attractive levels to go slightly long in both. As we do not have a decisive break of 3,80 just yet, and EUR periphery problems still looming on the market.

FX CHARTS









MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
31/12/10	3.86%	3.94%	4.05%	4.04%	4.25%	4.26%
03/01/11	3.84%	3.94%	4.03%	4.05%	4.25%	6.59%
04/01/11	3.83%	3.94%	4.05%	6.49%	4.22%	4.27%
05/01/11	3.85%	3.96%	3.73%	6.49%	4.13%	4.29%
06/01/11	3.53%	3.96%	4.07%	4.06%	4.28%	4.29%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
31/12/10	4.06%	4.27%	4.55%	4.75%	4.72%
03/01/11	4.07%	4.27%	4.56%	4.76%	4.72%
04/01/11	4.07%	4.28%	4.57%	4.77%	4.74%
05/01/11	4.08%	4.27%	4.55%	4.75%	4.72%
06/01/11	4.11%	4.31%	4.62%	4.81%	4.78%

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
31/12/10	4.26%	4.03%	4.86%	4.80%	5.46%	5.52%	5.62%	6.07%
03/01/11	6.59%	4.03%	4.86%	4.80%	5.46%	5.52%	5.62%	6.07%
04/01/11	4.27%	4.03%	4.86%	4.80%	5.46%	5.52%	5.62%	6.07%
05/01/11	4.29%	4.03%	4.86%	4.80%	5.46%	5.52%	5.62%	6.07%
06/01/11	4.29%	4.03%	4.86%	4.80%	5.46%	5.52%	5.62%	6.07%

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	10/12/01	13/01/26	90.550	4.80%	4000	9322	4076
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

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
31/12/10	17.65	19.15	19.75	20.30	3.10	4.70	0.65	0.87
03/01/11	17.65	19.15	19.75	20.30	3.10	4.70	0.65	0.87
04/01/11	18.00	19.20	19.65	20.00	3.10	4.70	0.65	0.88
05/01/11	17.75	18.80	19.50	20.00	3.10	4.70	0.65	0.88
06/01/11	17.60	18.85	19.55	20.00	3.10	4.70	0.65	0.88

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
31/12/10	2.9641	3.9603	-19.2%
03/01/11	2.9822	3.9622	-19.0%
04/01/11	2.9415	3.9433	-19.7%
05/01/11	2.9476	3.9095	-20.0%
06/01/11	2.9476	3.9095	-20.0%

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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