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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

FINANCIAL MARKETS DEPARTMENT

PAGES: 9

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PREVIEW: The week of February 18th 2011 to February 24th 2011

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
PPI	Feb 18	Jan	**6.5%**	6.3%	6.1%	A surge in price expectations. Beginning of the year seems a very suitable moment to pass more than a simple VAT hike to clients. Base effect from last year.
Industrial output	Feb 18	Jan	**15.0%**	10.0%	11.5%	Statistical jump owing to the sample change. More on this in the section "Employment <<resampling>> bullish for industrial output"
Retail sales y/y	Feb 23	Jan	**8.5%**	8.7%	12.0%	Positive substitution effects reversed. Significant drop in auto sales.

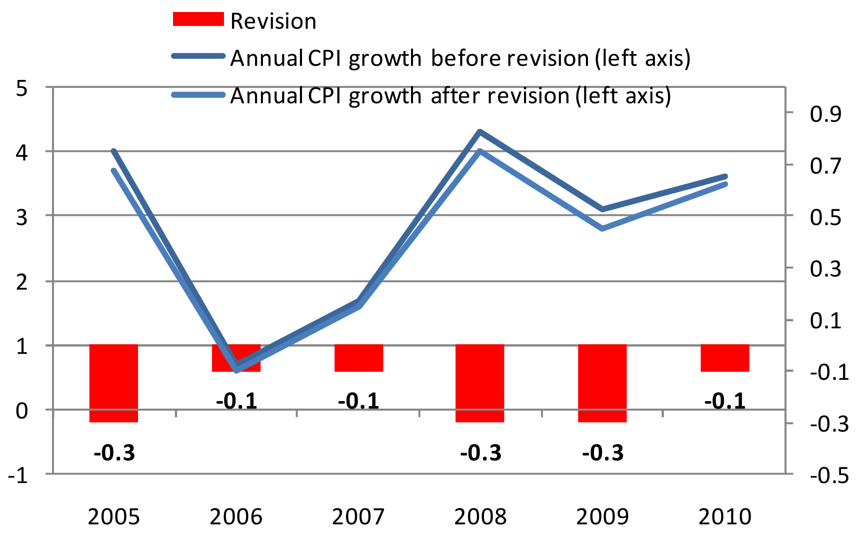
In Focus / Macroeconomics

Significant inflation growth In January

Annual inflation rate grew in January to 3.8% from 3.1% recorded in December (market consensus 3.5%). Monthly growth rate amounted to 1.2%.

Although the breakdown of inflation data after January is usually fragmentary, we can assess that half of the growth of inflation above expectations can be attributed to food prices (significantly above seasonal pattern, once again different from other CEE data…) and in the other half to categories, in which VAT hike could have been easily introduced (mainly state-controlled prices in housing category) without costly and time-consuming menu-changing process. Although the data are still subject to revision in March (change in consumption basket), we can already claim that February inflation is unlikely to exceed 4.0% (in the last 6 years we observed downward revision in the scale between 0.1 and 0.3pp. – see the graph). Moreover, it seems the price hikes have been already front-loaded and the probability of large, additional spillovers seems relatively small now.

Fig. The scale of revision of consumption basket as measured by the difference between “real time” inflation data in January and the subsequent revision.



Solid data from the labor market

Wages rose in January by 5.0% yoy (5.4% in December), as we expected. On the one hand the outcome is partially affected by the lower number of working days, on the other (positively) by base effects in mining and the solid growth in manufacturing (we see a 5-6% sustainable trend here). We expect that economic recovery and rising employment will support the ongoing trend in wages.

Employment in the enterprise sector rose by 3.8% yoy that is even faster than we expected (our expectations were the highest in market surveys). In absolute terms, employment rose by 122k, exceeding even the average recorded during the prosperity era (over the years 2006-2008). Although the monthly growth is mainly attributable to statistical effect (result of a change of statistical sample), it is a sign of a positive momentum of the current economic recovery. What is more, the increase in the number of enterprises employing more than 9 persons might corroborate the hypothesis that firms have been trying to optimize costs by mergers and acquisitions (hence a limited overall reduction of employment during the cycle).

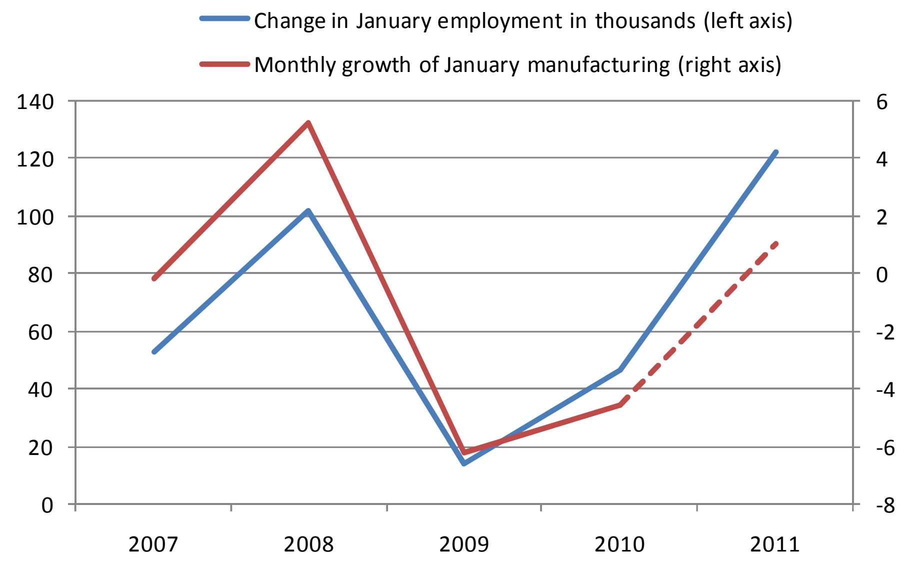
The data on employment clearly diverges from unemployment rate that shows movements on the labor market corresponding to the seasonal rather than fundamental factors (seasonal and intervention works, registrations aiming at exploiting health insurance). We pointed out to those facts while commenting on unemployment data.

Labor market data, together with unexpectedly high inflation data (even though it was mainly a result of a rise in VAT and supply factors) strongly increases the probability of a hike in the coming Monetary Board meeting. Although the Monetary Board can (at least partially) talk the growth of inflation down by publishing inflation projection excluding the effects of VAT rise (as was done in Hungary and the Czech Republic), the “Minutes” of the last meeting show the MPC is rather not in a mood of such a maneuvering. Rather, it would probably decide to reduce the risk of bigger volatility of the zloty and raise the rates already in March as a second move within “insurance” policy against unleashing inflation expectations.

Employment “resampling” bullish for industrial output

Due to a sudden jump in employment, connected with a change of statistical sample (more enterprises employing more than 9 workers), our industrial output forecast carries a substantial upwards risk towards 15.0%. The rationale behind the revision is presented in the graph below.

Fig January change in employment stemming from statistical reasons and the corresponding January monthly growth in industrial output



Moreover, the relation should hold regardless of the (announced earlier) output contraction in automotive sector, as this sector consists of large enterprises, excluded from statistically-driven jump. Once again, 15% is not fundamental – it is statistical in order to bridge the gap between statistics and macroeconomic reality. By the way, the aforementioned resampling would perfectly translate why the usually accurate GDP model (GDP is economy-wide based, not only on enterprises employing more than 9 workers) based on manufacturing underestimated the actual growth of the economy.

Implications: Brisk employment growth, solid wages, surge in inflation and now the possibility of a sudden jump in industrial output make March hike very, very likely. Along with hawkish Minutes one may wish to exploit the surge in output counting on a sudden move in EURPLN and in the short interest rates.

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	**3.7↑**
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	12.3	11.9
NBP repo rate (end-of-year)	5.00	5.00	3.50	3.50	4.25

Indicator			2010		2011	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	3.0	3.5	4.2	4.5	4.2	3.8
Inflation rate (%, average)	3.0	2.1	2.6	2.9	**3.7↑**	**3.7↑**
NBP repo rate (end-of-quarter)	3.50	3.5	3.5	3.50	**4↑**	**4.25↑**

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

Fixed Income

It is all about inflation…

Another week, another surprise. After a quiet start we had latest CPI data that strongly surprised on the upside (3.8% y/y ag. 3.4% expected). As a result rates, especially in the front end jumped up rapidly by some 15bp (2Y IRS moved from 5.13 to 5.29%). Long end suffered much less and the curve flattened significantly. We must admit, such data is a bit confusing and slightly undermines our general view that hike expectations are seriously overshot and that we're not going to see a 100bp+ cycle. We still don't think it will actually happen, we still don't see value in paying rates in the front end. But we see risks that this trend will continue further, especially if we see another economic data supporting tightening. Also we could see Council members turning more to hawkish side. Therefore we decided to stay on the sidelines for a moment and wait for either confirmation of inflation staying on the growing path, or other data that would show the recent reading was just a one-off event based on food prices shock and VAT increase. That would probably mean, we're still about to see better levels to enter receive positions.

	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	2/28/2011	-	4.291%	1/31/2011
2Y T-bond OK1013	3/9/2011	-	5.031%	2/9/2011
5Y T-bond PS0416	3/9/2011	-	5.642%	1/5/2011
10Y T-bond DS1020	3/16/2011	-	6.210%	1/12/2011
20Y T-bond WS0429	3/16/2011	-	6.246%	1/12/2011

AUCTIONS

Money Market

Surplus of the cash comparing to the reserve requirements is growing relatively slowly this month, therefore the cost of carry remains well above 3%. Today's OMO will determine this figure till the end of the current settlement period. We bet on underbid auction.

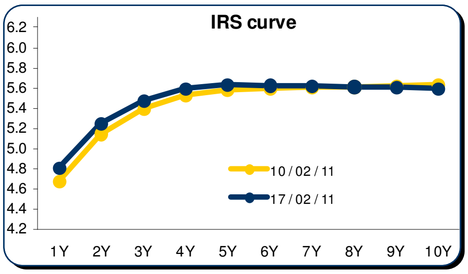
Surprising CPI figure

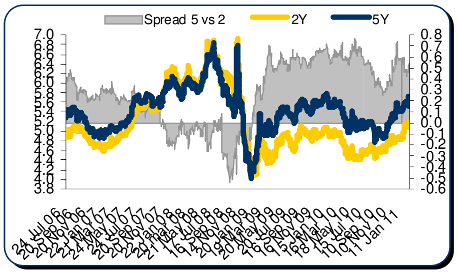
CPI figure surprising for all the market participants (3.8% vs 3.4%). Since we are on very uncomfortable level hikes are inevitable and March became very probably term for further tightening. After CPI ois curve made 10-15 bps up.

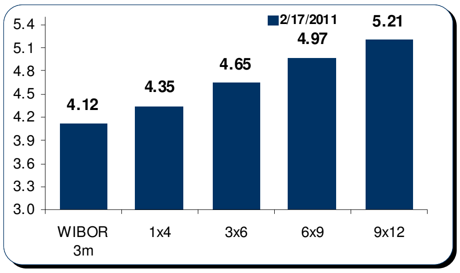
T-bills expected to be cheaper on next tender

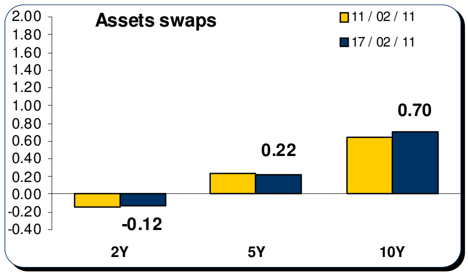
T-bills stable during last tender with an average yield 4.35%. On Monday those papers will be much cheaper.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty trading side trend

At beginning of the week worse global sentiment had took EURPLN's rate near to last traded high – 3.9560 was touched. But… While market was involved in building short PLN positions surprisingly high CPI figure has come out – 3.8% y/y (expectations were 3.2-3.3). As a result PLN shorts were bought back and once again we were trading 3.90 area.

Conclusion: PLN interest rates have come back to play (softened by Africa/Middle East developments)

Implied curve offered

Weaker (though temporary) PLN has not discouraged vega sellers. While short end was traded relatively stable (1M in 9.0-9.4 range), long end has printed new low – 1Y has been traded at 11.3 (12.3 this year open, 11.6 week ago). Remaining parts of curve (RRs and FLYs) and currency spread have been priced at same levels.

Short-term forecasts:

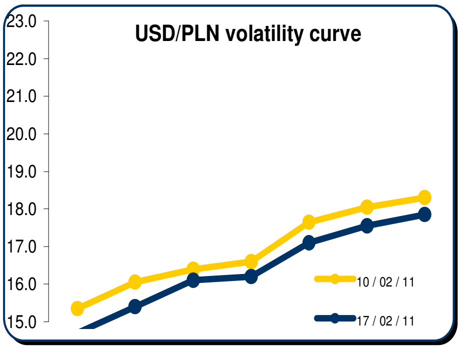
SPOT

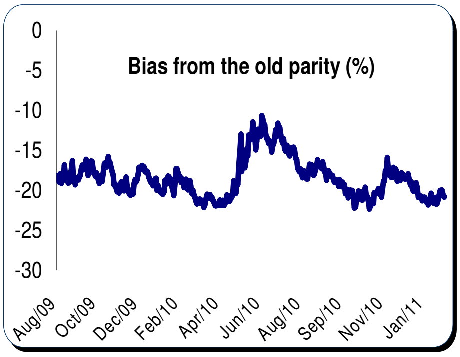
Main supports / resistances:
EUR/PLN: 3.8400 / 3.9600
USD/PLN: 2.8000 / 2.9200

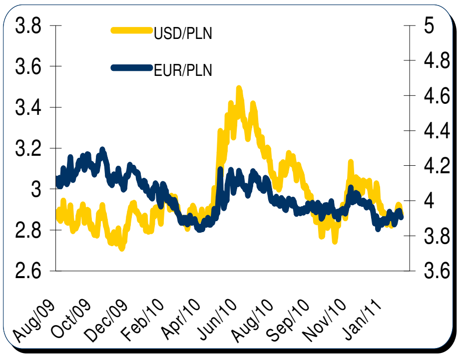
Sticking to our view, we are short at 3.94, 3.97 S/L and 3.88 P/T. Increased probability of rate hikes supports such scenario.

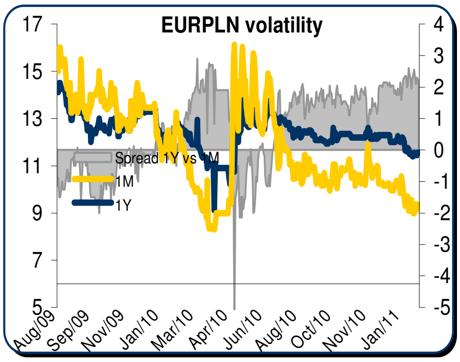
OPTIONS
Vega is priced lower (1Y tenor 12.3 to 11.5 since 1st of Jan!) and it is hard to convince us to catch a falling knife. Gamma is still priced about realized – 9.0% implied, 9.2 realized. We have squared it up.

FX CHARTS


USD/PLN volatility curve
23.0
22.0
21.0
20.0
19.0
18.0
17.0
16.0
15.0
10 / 02 / 11
17 / 02 / 11


Bias from the old parity (%)
0
-5
-10
-15
-20
-25
-30
Aug/09
Oct/09
Dec/09
Feb/10
Apr/10
Jun/10
Aug/10
Sep/10
Nov/10
Jan/11


USD/PLN
EUR/PLN
3.8
3.6
3.4
3.2
3
2.8
2.6
5
4.8
4.6
4.4
4.2
4
3.8
3.6
Aug/09
Oct/09
Dec/09
Feb/10
Apr/10
Jun/10
Aug/10
Sep/10
Nov/10
Jan/11


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
17
15
13
11
9
7
5
4
3
2
1
0
-1
-2
-3
-4
-5
Aug/09
Sep/09
Nov/09
Jan/10
Mar/10
Apr/10
Jun/10
Aug/10
Oct/10
Nov/10
Jan/11

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
11/02/11	3.96%	4.09%	4.18%	4.22%	4.40%	4.41%
14/02/11	3.96%	4.09%	4.22%	4.22%	4.19%	6.59%
15/02/11	4.00%	4.10%	4.22%	6.49%	4.04%	4.40%
16/02/11	3.95%	4.12%	4.24%	4.23%	4.42%	4.42%
17/02/11	4.00%	4.12%	4.28%	4.23%	4.44%	4.42%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
11/02/11	4.23%	4.44%	4.81%	5.02%	5.00%
14/02/11	4.21%	4.46%	4.84%	5.05%	5.03%
15/02/11	4.21%	4.47%	4.81%	5.03%	5.00%
16/02/11	4.20%	4.46%	4.81%	5.03%	5.00%
17/02/11	4.17%	4.45%	4.77%	5.01%	4.98%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IF
11/02/11	4.41%	4.37%	5.14%	5.00%	5.58%	5.81%	5.6
14/02/11	6.59%	4.37%	5.14%	5.00%	5.58%	5.81%	5.6
15/02/11	4.40%	4.50%	5.13%	5.13%	5.65%	5.87%	5.6
16/02/11	4.42%	4.48%	5.26%	5.12%	5.63%	5.87%	5.5
17/02/11	4.42%	4.51%	5.25%	5.12%	5.64%	5.86%	5.6

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sc
52W TB	11/01/31	12/01/31	95.841	4.35%	2000	2968	19
OK0113	10/12/01	13/01/26	90.550	4.80%	4000	9322	40
PS0416	10/10/13	16/04/25	99.300	5.14%	3000	3414	24
DS1020	11/01/12	19/04/25	93.022	6.21%	2250	4252	22

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		2
date	1M	3M	6M	1Y	1M	1Y	1
11/02/11	16.20	16.75	17.65	18.30	2.50	4.50	0.
14/02/11	15.35	16.35	17.25	18.00	1.80	3.75	0.
15/02/11	15.50	16.55	17.35	18.10	1.80	3.75	0.
16/02/11	15.55	16.50	17.35	18.10	1.80	3.75	0.
17/02/11	15.40	16.20	17.10	17.85	1.80	3.75	0.

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
11/02/11	2.9116	3.9370	-20.1%
14/02/11	2.9219	3.9337	-20.0%
15/02/11	2.9159	3.9398	-20.0%
16/02/11	2.8864	3.9123	-20.7%
17/02/11	2.8790	3.9068	-20.8%

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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