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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of May 20th 2011 to May 26th 2011

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Industrial output	May 20	Apr	**7.7%**	7.1%	7.0%	One working day less. Monthly momentum without a change. Base effect from last year.
Producer prices	May 20	Apr	**8.1%**	8.6%	9.3%	Copper leveled off, as did EURPLN rate. Huge base effects from the last year.
Core inflation	May 20	Apr	**2.1%**	2.1%	2.0%	Exogenous price rises slowly muddle through relative adjustments implying higher core inflation.
Retail sales	May 25	Apr	**16.3%**	14.9%	9.4%	Huge base effect from last year. The peak of Easter sales should have occurred in April.

In Focus / Macroeconomics

Real sphere strong. MPC wants to frontload hikes as it sees clouds on the horizon.

Recent data from labor market confirmed the recovery is deeply entrenched – wages rise at a pace close to threshold 5-6% regarded by some MPC members as worrying (Belka), whereas employment continues to grow steadily on monthly basis. Publications makes May decision warranted, the more so MPC seems to be willing to accelerate hikes before expected slowdown in economic activity kicks in. Therefore we expect them to hike in July and then cease fire (at least temporarily) on falling headline inflation. Such a limbo would (along with better fiscal position) support Polish bonds, especially the mid and the long end.

Turning to macro-details, employment in enterprises grew by 3.9% y/y. On a monthly basis employment rose by 5k – a relatively poor result for April and current phase of cycle. However, we believe that the reason for slow job growth was a strange behavior "administrative and support service activities" category which shed more than 10k jobs in March and did not make them up in April (as was usually the case – this has to do more with a statistical failure than an real change in hiring activity). All in all we believe that 5-6k jobs were created in manufacturing, construction and trade – fair enough to think the recovery is still on track. We will be able to confront this thesis with the reality along with the publication of the Statistical Bulletin. We are ready to risk a statement, however, that labor market is still in very good shape – structural break of employment would have had consequences for wages growth too (or rather mainly, as reflected by the cut of the number of hours worked). Meanwhile, wages surprised to the upside, accelerating to 5.9% y/y from 4.0% reported in March. This is even more impressive taking into account negative difference in working days in April. Only partly this jump can be explained by bonuses in copper mining. We still believe that in the coming months wages will grow by 5-6%, exceeding the level NBP regards as neutral from inflation perspective.

Recent macro developments encouraged MPC members to speak. First and foremost Belka repeated that MPC is still in a tightening cycle. However, at the same time he admitted he opposes just-in-case hikes or substantial scale of monetary tightening (strange given the voting pattern of recent hikes – more on this below). Moreover, he thinks inflation will recede, core inflation is still low and there is no trace of second round effects. Bratkowski, on the other hand, is selling the idea of fast rate hikes as an insurance against second round effects. In his opinion inflation will reach target in 2012 (most probably in its early part) and GDP growth will lose steam. Chojna-Duch seems the most hawkish among the recently vocal members. However, it may be tricky since she is not citing arguments but rather a scale of tightening (2 more hikes probable). All in all, MPC members are rather mixed, reacting mostly to current data, preserving the "structural" dovishness (deeply entrenched fears of looming economic slowdown).

The same message seems to be flowing from the May meeting "Minutes". This time the document was fairly short and concise – MPC members focused on the scale of tightening and the timing of hikes. Drawing from MPC actions (and the distribution of votes; seemingly 9:1 for a hike in April and May), the majority backs fast monetary tightening in order to prevent second-round effects and minimize the risk of anchoring higher inflation expectations. However, at the same time MPC seems to be perfectly unanimous with regard to economic slowdown in the latter part of the year. Such a diagnosis further supports the view that the MPC will be rather willing supply the market with more dovish accents as soon as inflation begins to fall (July).

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.8	4.4
Inflation rate (%, average)	2.4	4.3	3.5	2.8	4.1
Current account (% of GDP, average)	-4.5	-5.3	-1.6	-3.1	-4.8
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	4.75

Indicator	2010			2011		
	Q2	Q3	Q4	Q1	Q2	Q3
GDP y/y (%)	3.5	4.2	4.5	4.4	4.4	4.4
Inflation rate (%, average)	2.1	2.6	2.9	3.7	4.3	4.3
NBP repo rate (end-of-quarter)	3.5	3.5	3.50	4.00	4.25	4.50

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

Fixed Income

Now they're talking

Last week's unexpected rate hike caught the market by surprise and caused immediate negative reaction with yields pushing higher by some 10bp. Few days later however, it starts to look that such decision will be quite positive in the longer term. Not only has the MPC hiked rates again, but also their rhetoric has evolved towards more cautious and predictable. It seems that Council members became aware of potential risks of second round effects and decided to react rather sooner than later to prevent them from actually materializing. Previously considered scenarios of a policy mistake that could lead to losing control of inflation and falling behind the curve don't seem tom be valid any longer, which is definitely supportive for bond market. Concentrating policy tightening actions will allow the cycle to finish sooner and possibly at a lower level. Therefore rate path priced in the curve isn't something can really happen. Assuming that 1y1y is priced reasonably, further forwards should be either flat or lower and not 30bp higher. Considering these facts, we are positive on bonds at current levels, we prefer 5y sector, which seems to have most value - it can outperform 10y, as along with the curve moving down in yields, we see some steepening in 5y ag 10y spread.

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	5/30/2011	-	4.458%	3/28/2011
2Y T-bond OK1013	6/9/2011	-	5.112%	5/12/2011
5Y T-bond PS0416	6/9/2011	-	5.614%	18/5/2011
10Y T-bond DS1020	7/20/2011	-	6.210%	1/12/2011
20Y T-bond WS0429	7/20/2011	-	6.246%	1/12/2011

Money Market

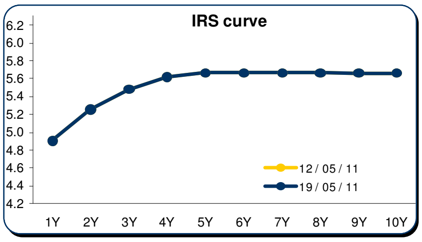
Cheap cash stays for another week

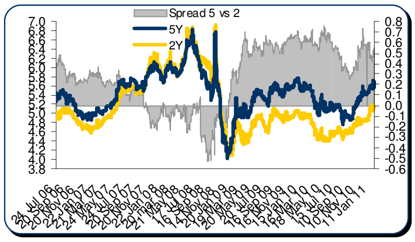
Cheap cash stays for another week, and after rate hike polonia stays even further from reference rate approximately 65 bp. Looks like whole May will be like that as we head slowly into the end of the reserve period.

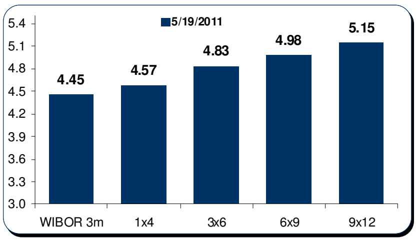
Expect solid demand of t-bill auction

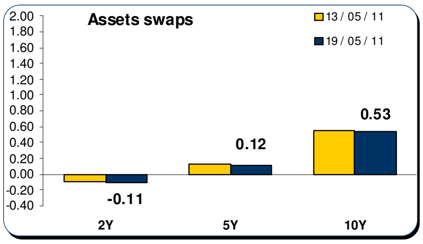
After friday's CPI reading which was more or less in line with market expectations market got a relief, rates came a bit lower, and we had a solid demand on monday's t-bill auction.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in tight range

We have closed last week about 3.9200, and we most probably end around 3.9200 again this week . World tensions are eased by MoF inflow and this is how we may end this week story. EURPLN top was at 3.9440, low at 3.9125. Market positioning is a bit of a puzzle but with such XXX/PLN supply we should easily find some PLN shorts around.

Vols lower

Quiet price action on spot affects realized volatility in the obvious way – weekly realized is only about 6% (just compare it with Hungarian 9%). Pressured implied ATMs and smile were sold off., especially short end. Tenors were traded as specified below: 1M 7.6 (8.4 week ago), 3M 8.4 (8.85), 1Y 10.3 (10.55), 3M 25D RR 1.5 (1.65).

Short-term forecasts:

SPOT

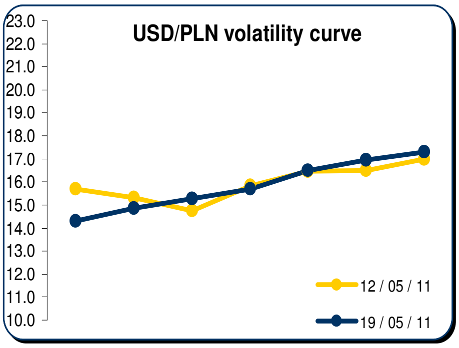
Main supports / resistances:
EUR/PLN: 3.8900 /3.9600
USD/PLN: 2.6800 / 2.8200

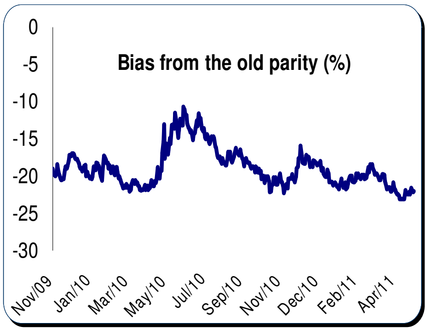
We are short at 3.94, would add at 3.96, S/L 3.98, P/T 3.88.

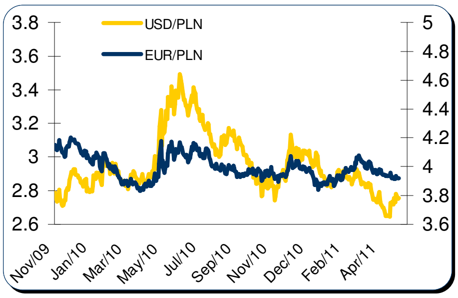
OPTIONS

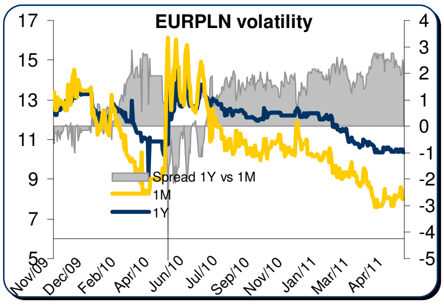
We think the back end of the curve is well supported, taking into account the lowest levels since 2008 and the fact that due to expected rate hikes the forward delta gamma offers additional value . Although cheap in numbers hard to see it profitable - we have squared long gamma.

FX CHARTS


USD/PLN volatility curve
12 / 05 / 11
19 / 05 / 11


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		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
13/05/11	4.31%	4.42%	4.46%	4.41%	4.65%	4.65%
16/05/11	4.33%	4.42%	4.46%	4.48%	4.65%	6.59%
17/05/11	4.33%	4.45%	4.50%	6.49%	4.67%	4.66%
18/05/11	4.35%	4.45%	4.48%	4.51%	4.64%	4.67%
19/05/11	4.35%	4.45%	4.52%	4.51%	4.66%	4.67%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
13/05/11	4.48%	4.60%	4.90%	5.10%	5.05%
16/05/11	4.57%	4.83%	5.00%	5.19%	5.13%
17/05/11	4.57%	4.83%	5.03%	5.21%	5.16%
18/05/11	4.57%	4.83%	4.99%	5.17%	5.15%
19/05/11	4.56%	4.70%	4.98%	5.17%	5.13%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)						
date	1Y		2Y		5Y	
	WIBOR	TB	IRS	OK0112	IRS	PS0511
13/05/11	4.65%	4.65%	5.20%	5.10%	5.53%	5.66%
16/05/11	6.59%	4.62%	5.20%	5.11%	5.53%	5.69%
17/05/11	4.66%	4.60%	5.17%	5.06%	5.50%	5.66%
18/05/11	4.67%	4.62%	5.19%	5.07%	5.48%	5.62%
19/05/11	4.67%	4.61%	5.19%	5.08%	5.50%	5.62%

PRIMARY MARKET RATES

Last Primary Market Rates	au. date	maturity	avg price	avg yield	supply	demand
52W TB	11/01/31	12/01/31	95.841	4.35%	2000	2968
OK0113	11/04/13	13/01/26	89.159	5.16%	5500	7385
PS0416	11/01/05	16/04/25	97.078	5.64%	6500	2795
DS1020	11/01/12	19/04/25	93.022	6.21%	2250	4252

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR	
date	1M	3M	6M	1Y	1M	1Y
13/05/11	15.03	15.60	16.25	17.10	2.15	3.80
16/05/11	15.43	15.90	16.55	17.40	2.05	3.90
17/05/11	15.08	15.80	16.50	17.40	2.05	3.90
18/05/11	14.83	15.70	16.45	17.35	2.25	3.90
19/05/11	14.88	15.70	16.50	17.30	2.05	3.80

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
13/05/11	2.7321	3.9135	-22.4%
16/05/11	2.7817	3.9330	-21.6%
17/05/11	2.7707	3.9269	-21.8%
18/05/11	2.7501	3.9205	-22.2%
19/05/11	2.7570	3.9205	-22.1%

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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