



TOP NEWS FROM THE POLISH MARKET

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- MPC member Sławiński: The growth of inflation will be gradual
- More dovish Sławiński's statement increases the likelihood of no hikes in the near future
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- Strong data on retail sales for December, deflation in retail sales prices for a third month in a row
- Unemployment rate rose a notch due to seasonal factors
- Core inflation remained at 1.6% y/y in December, confirming benign inflationary pressure
- Budget deficit amounted to 25.1 b PLN in 2006, 5.4 b below the limit
- No budget surplus after January expected
- 2007 Budget Act approved in the Sejm

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MACROECONOMICS

MPC member Wasilewska – Trenkner: The postponement of the hikes increases the risk that the tightening of monetary policy will have to be stronger in the future

MPC member Sławiński: The growth of inflation will be gradual

More dovish Sławiński's statement increases the likelihood of no hikes in the near future

GDP grew by 5.8% in Q4 – strong growth in investment in Q4, consumption growth stable

Strong data on retail sales for December, deflation in retail sales prices for third

The MPC member Halina Wasilewska–Trenkner said that “the postponement of the interest rates hikes increases the risk that the tightening of monetary policy will have to be stronger and the effects may be delayed”. This announcement indicates that in the opinion of Wasilewska–Trenkner the MPC is currently “behind the curve” and can miss the moment when the CPI will rapidly grow. Then rapid hikes would be necessary. According to Wasilewska–Trenkner the December data have changed the inflation outlook. She said that lower industry output with high wages growth results in growth of unit labour costs. It is however easy to see that lower output is an unfavorable trading days effect and after the seasonal adjustment the annual dynamics were similar to November. We have observed the acceleration of wages dynamics but it does not necessarily have to pass through to inflation.

A different view has been expressed by another MPC member Andrzej Sławiński. He doesn't agree that if the MCP doesn't raise the rates inflation will exceed the middle of inflation target. In his opinion the growth of inflation will be gradual. He emphasized that the Phillips curve flattened due to globalization. For him the most serious risk factor for inflation is the labour market but he mentioned that high wages in December must be corrected by one-off factors (bonuses in mining).

He didn't exclude the tightening of monetary policy but it may occur when real GDP exceeds the potential one, which may be within two years.

One of the most dovish MPC members Stanisław Nieckarz said that annual food prices dynamics in H1 will amount to 2.5-3.0% but in H2 these dynamics will drop to 2.0-2.5%. The average annual CPI will be at 2.5%, which in our opinion has been overestimated.

Our comments:

In our opinion the most important opinion is the view expressed by Professor Sławiński. He is currently a median voter and his view will have a strong impact on the final MPC decision. His statement was significantly more dovish than the previous one. He maintained the opinion that the MPC may increase the rates but he added that it may occur in two years, in contrast with his previous statement. We believe that due to low current headline and core inflation the MPC will not hike the rates until at least the middle of the year.

Preliminary CSO estimates indicate that GDP rose by 5.8% in 2006, which translates into further steepening of the economic growth path. We estimate the annual growth rate of GDP for the fourth quarter at 6.6%.

The data on GDP are in line with our expectations, however a different structure of growth was recorded. The rise in private consumption was lower than we anticipated (5.2% vs forecast 5.4%), which was substituted by stronger growth in investment (16.7% vs forecast 15.9%). In Q4 itself the GDP growth reached 6.6% y/y, which was fastest pace since 2004. Consumption in Q4 grew by 5.3% and investment by 19.3% (quarterly rates are our own preliminary estimates). On the supply side we have seen continuation of trends observed in previous quarters – value added in the industry was just below 8% in Q4, market services growth continued to speed up (5.0% in whole year, ca. 6% in Q4), also constructions output was high (near 20% in Q4) due to favorable weather conditions.

Decomposition of GDP growth should not pose a worry to the MPC – it has been stressed repeatedly by the MPC members that the rising investment should increase potential output reducing mid-term inflationary pressure; also consumption growth did not accelerate in Q4.

Retail sales were in December by higher 22.7%, in nominal terms, compared to November and higher by 13.3% than in December 2005. In real terms retail sales grew by 13.7% y/y, which means that December was the third month in a row when deflation in retail sales prices was recorded.

month in a row.

Unemployment rate rose a notch due to seasonal factors

Core inflation remained at 1.6% y/y in December, confirming benign inflationary pressure

Budget deficit amounted to 25.1 b PLN in 2006, 5.4 b below the limit

No budget surplus after January expected

2007 Budget Act approved in the Sejm

The CSO also released the data on unemployment for December. In line with our expectations, the unemployment rate was a notch higher than in November and amounted to 14.9%. This increase was mainly due to seasonal factors. The favourable weather conditions, however, limited the impact of seasonal factors that usually cause unemployment to go up by 0.3-0.4 pct. in December. The unemployment rate will peak in January at 15.2% and fall again starting in March.

Two core inflation measures rose, one dropped and two remained unchanged (including net inflation remaining at 1.6%) in December. The data confirm a lack of significant inflationary pressure in the economy, including pressure arising from the output gap narrowing. We expect core inflation to rise in 2007, but we expect 2.2-2.3% to be the upper threshold for the indicator within the whole year. Apart from insignificant demand pressure we also experienced dropping fuel and food prices, which pushed the CPI below net inflation. The data on net inflation only strengthen our expectations that no interest rate hikes will occur in the first half of the year.

The MF stated that the 2006 deficit reached 25.1 b PLN (vs 30.5 set as the limit). Budget income topped the plan by 2.4 b PLN (this includes PIT surplus of 900 m, VAT and CIT roughly in line and excise income lower by 600 m). In December VAT income was somewhat lower than in previous months, which can suggest a shift of some income to January. A similar maneuver was performed in previous years, but this year the scale of the shift is somewhat lower (ca. 1 b PLN compared to ca. 3 b PLN in 2004-05). Total spending was 3 b below the limit despite e.g. higher FUS subsidy (1.1 b) or non-expiring spending (2.4 b), transferred as reserves to the 2007 budget. The budget execution has been excellent throughout the year, and high the income observed in recent months is also a good sign for the budget execution in 2007.

Elżbieta Suchocka-Roguska of the MF stated that a budget surplus is unlikely to occur in January 2007 (contrary to 2006, when a surplus of 600 m PLN was reached). She pointed to higher spending at the beginning of the year, including CAP spending (though she refused to give any specific figures).

The 2007 Budget Act was approved in the Sejm last week. As expected, most of Senat's amendments were accepted (including the teachers' rise financed from higher NBP revenue). The MPs are not allowed to increase the deficit, and the amendments are mostly insignificant so they should not influence the budget execution. The total budget income is set at 229 b PLN, spending at 259 b.

FIXED INCOME

Negative sentiment hit polish yield curve

RECOMMENDATION:

Negative sentiment that spread over emerging markets last week, had impact on polish yield curve as well and we've observed rates drifting higher constantly. Data releases, including unemployment and retail sales were neutral for the market, as well as GDP data published this morning. This week most important issues will be the MPC statement and new inflation projection. We do not expect any significant change neither in the future CPI path, nor the Council's statement, which should provide some support for the market. We still think we should fluctuate in a range, with current bond prices closer to lower band, however, since recent moves were not based on local factors, we can see some further aberrations, following either core markets or overall sentiment.

Market still in range.

MONEY MARKET

**Cheap end of the reserve ahead
Weakening PLN and the whole region affected interest rates**

T-bills sharply down, recovery expected

RECOMMENDATION:

Stable carry whole week with the cheap end on Friday. Smaller than expected open market operation (20 billion pln vs 22 expected) and substantial reduction rate 70.5% pushed the shortest rates down. Hence we bet on the cheap end of the reserve next week.

Still lots of volatility for longer terms, with bearish sentiment taking ground. It started after comments of the MPC member Wasilewska-Trenkner, and even though the market used to be very sceptic as far as her comments are concerned, this time it was a very good incentive to start the correction. Then weakening PLN and the whole region gave it accelerator.

The average yield on Polish benchmark 52-week T-bill dropped aggressively down to 4.08 from 4.2%. The Ministry sold all 0.9 billion PLN of 52-week papers giving the bid-to-cover ratio of 1.47. Yields should recover as soon as during the next auction, because 4.08% does not fit to any MM curve.

Take current levels to build receive position.

FOREIGN EXCHANGE

Zloty weaker

Volatility higher

RECOMMENDATION:

Zloty stable

Long Vega

Last week, as anticipated, the Zloty weakened to 3.9500. With EUR/USD at about 1.2950, the USD/PLN traded between 3.0200 and 3.0500. The weakening of the Zloty is broadly seen as a result of increase in global risk aversion which leads to outflow of capital from emerging market economies.

Volatilities traded higher last week, with the main reason for that being of course the weaker Zloty. On Friday 1M ATM EUR/PLN traded at a 6-month high of 8.5 (mid), whereas 1Y at 7.4. 1M USD/PLN traded at 9.5, while the long end (1Y) decreased only a bit to 9.3.

RECOMMENDATION:

Spot:

Main supports / resistances:

EUR/USD: 1.2760 / 1.3010

EUR/PLN: 3.9200 / 3.9500

USD/PLN: 3.0200 / 3.0500

In the following week we may see Zloty trade within a range. That is why we do not recommend any directional positions.

Options:

Any significant move of the spot outside the range should result in a considerable change of the volatilities' levels. That is why we recommend long Vega positions the following week.

MARKET PRICES UPDATE**MONEY MARKET RATES****Money market rates (Closing mid-market levels)**

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
22-01-07	4.10%	4.18%	4.17%	4.28%	4.32%	4.42%
23-01-07	4.10%	4.19%	4.18%	4.28%	4.34%	4.43%
24-01-07	4.11%	4.20%	4.19%	4.28%	4.36%	4.42%
25-01-07	4.12%	4.19%	4.21%	4.28%	4.39%	4.42%
26-01-07	4.12%	4.19%	4.21%	4.28%	4.39%	4.42%

FRA MARKET RATES**FRA Market Rates (Closing mid-market levels)**

date	1X4	3X6	6X9	9X12	6X12
	22-01-07	4.22%	4.26%	4.39%	4.50%
23-01-07	4.22%	4.29%	4.44%	4.53%	4.56%
24-01-07	4.22%	4.30%	4.46%	4.56%	4.57%
25-01-07	4.22%	4.30%	4.45%	4.55%	4.56%
26-01-07	4.22%	4.30%	4.45%	4.55%	4.56%

FIXED INCOME MARKET RATES**Fixed Income Market Rates (Closing mid-market levels)**

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK1208	IRS	PS0511	IRS	DS1017
22-01-07	4.42%	4.19%	4.71%	4.31%	4.98%	4.83%	5.05%	5.14%
23-01-07	4.43%	4.15%	4.72%	4.32%	4.98%	4.85%	5.06%	5.16%
24-01-07	4.42%	4.17%	4.73%	4.34%	5.01%	4.87%	5.11%	5.20%
25-01-07	4.42%	4.17%	4.70%	4.31%	4.98%	4.80%	5.07%	5.16%
26-01-07	4.42%	4.16%	4.68%	4.27%	4.99%	4.80%	5.10%	5.19%

PRIMARY MARKET RATES**Last Primary Market Rates**

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	07-01-22	08-01-23	96.033	4.09%	900	1474	900
OK1208	06-12-06	08-12-12	91.311	4.62%	3800	10428	3800
PS0412	07-01-17	12-04-25	98.887	4.99%	2500	12108	2500
DS1017	07-01-10	17-10-25	100.070	5.24%	1800	4148	1800

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
22-01-07	9.00	9.10	9.20	9.30	1.20	1.30	0.40	0.45
23-01-07	9.00	9.10	9.20	9.30	1.20	1.30	0.40	0.45
24-01-07	9.40	9.40	9.40	9.40	1.20	1.30	0.40	0.45
25-01-07	9.40	9.40	9.40	9.40	1.20	1.30	0.40	0.45
26-01-07	10.00	9.50	9.50	9.40	1.40	1.30	0.40	0.45

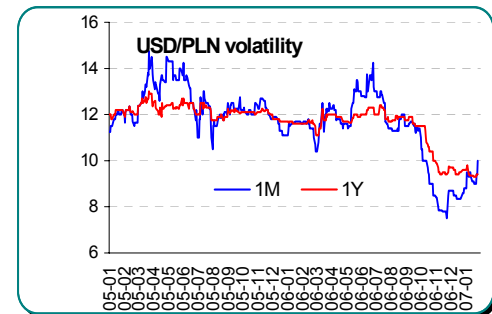
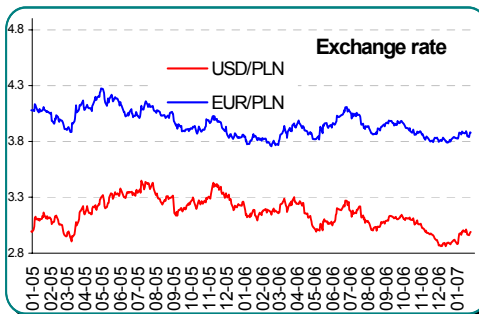
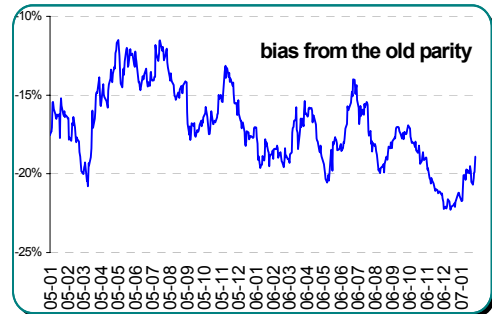
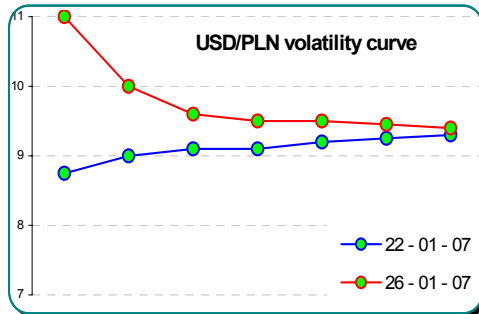
PLN SPOT PERFORMANCE**PLN spot performance**

date	USD/PLN	EUR/PLN	bias
22-01-07	2.9630	3.8395	-20.68%
23-01-07	2.9747	3.8630	-20.27%
24-01-07	2.9845	3.8825	-19.93%
25-01-07	2.9912	3.8785	-19.90%
26-01-07	3.0334	3.9208	-18.92%

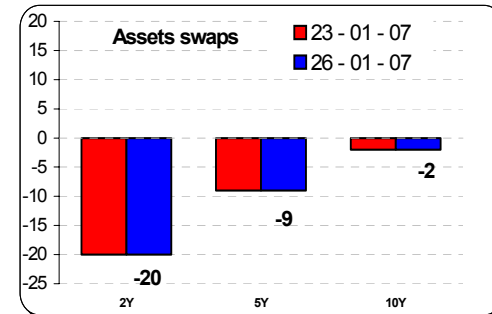
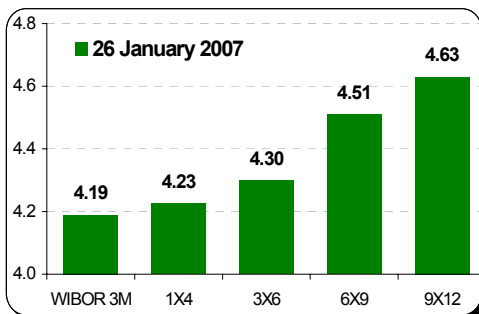
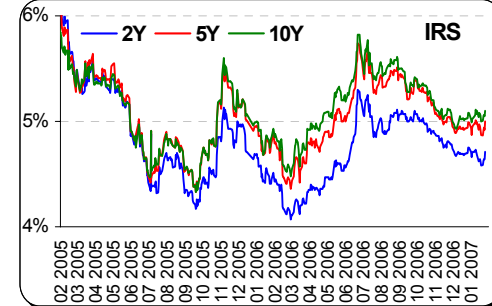
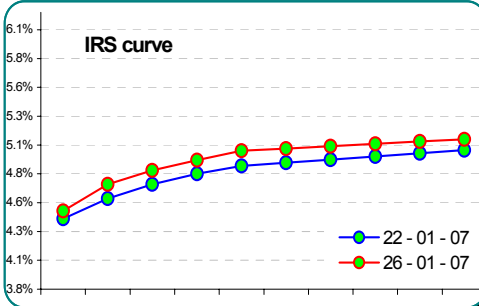
Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50
Mid-market volatility of vanilla option strategies

CHARTS

Foreign Exchange



Fixed Income



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CALENDAR

Macro

	October	November	December	Data Release	BRE Bank forecast
CPI m/m	0.1%	0.0%	-0.2%	15-02-07	
CPI y/y	1.2%	1.4%	1.4%	15-02-07	
PPI m/m	-0.5%	-0.7%	-0.3%	19-02-07	
PPI y/y	3.2%	2.5%	2.8%	19-02-07	
Industrial production growth m/m	4.3%	-2.7%	-6.8%	19-02-07	
Industrial production growth y/y	14.8%	12.0%	5.7%	19-02-07	
Average wages in enterprise sector [PLN]	2658.0	2759.7	3027.5	15-02-07	
Average wages in enterprise sector y/y	4.7%	3.1%	8.5%	15-02-07	
Unemployment	14.9%	14.8%	14.9%	23-02-07	
Budget realisation (%)	54.4%	60.7%	82.3%	16-02-07	
Current account [EUR mn]	-482	-510		12-02-07	
Balance of foreign trade in goods (transaction basis) [EUR mn]	-269	-246		12-02-07	
Exports growth y/y (transaction basis)	24.0%	22.0%		12-02-07	
Imports growth y/y (transaction basis)	27.7%	20.0%		12-02-07	
Current account [% of GDP]	-1.9%	-1.8%		12-02-07	
Money supply (M3)	458.6	465.7	477.1	14-02-07	
Money supply growth y/y	12.3%	14.4%	15.7%	14-02-07	
Total PLN loans [PLN bn]	353.0	361.5	367.3	14-02-07	
Households PLN loans	183.0	183.3	188.5	14-02-07	
Corporate PLN loans	139.6	141.3	143.3	14-02-07	
Total PLN deposits [PLN bn]	378.4	385.3	397.1	14-02-07	
Households PLN deposits	214.3	214.8	223.2	14-02-07	
Corporate PLN deposits	113.8	116.9	124.9	14-02-07	
NBP intervention rate	4.00%	4.00%	4.00%	31-01-07	4.00%

Auctions

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4.208%	16-01-06
26 Week T-bills	-	-	3.943%	24-04-06
52 Week T-bills	05-02-07	-	4.085%	22-01-07
2Y T-bond OK1208	07-02-07	-	4.617%	06-12-06
5Y T-bond PS0412	21-02-07	-	4.985%	17-01-07
10Y T-bond DS1017	11-04-07	-	5.240%	11-10-06
20Y T-bond WS0922	14-03-07	-	5.707%	13-09-06

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