FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

TWO-WEEKS YEAR END EDITION

PREVIEW: The week of December 18th 2009 to January 7th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Core inflation y/y	Dec 22	Nov	**2.8%**	2.9%	2.9%	After the CPI publication we revised down our core inflation forecast. However, inflation still stubbornly high taking account of the phase of the cycle.
Retail sales y/y	Dec 23	Nov	**4.1%**	4.6%	2.1%	There is an upside risk on the back of stronger (unanticipated) auto sales in November.
MPC decision	Dec 23	-	**3.5%**	3.5%	3.5%	Farewell meeting. No decisions concerning rate. New MPC candidates speak about rather uneventful H1 2010. We expect rate hikes in H2 2010.
PMI	Jan 4	Dec	**53.5pts.**	-	52.4pts.	Strong momentum of the economy continues.
MoF CPI forecast y/y	Jan 4	Dec	**3.7%**	-	3.3%	Driven by massive base effects from 2008 (large drops of fuel prices). Core inflation close to 2.8% y/y.

<u>We wish You a Merry Christmas and lots of profit in 2010!</u>

The next issue of the report will be released 7th January 2010

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In Focus / Macroeconomics

Local fundamentals on the upswing…but global reigns

Last week was pretty abundant with macroeconomic data. In fact, we got all we need to confirm the ongoing positive momentum of the economy. Employment report confirmed the labor demand is on the rise and we correctly discerned the underlying trends. 9.8% growth of industrial output was crushing…but went unnoticed – no impact on the zloty. Changes in global capital circulation and worries about the fiscal policy in euro area peripherals are in the center of focus at the moment. All these factors are euro and … zloty negative. That is why, we expect the pace of zloty appreciation to slow a bit in the weeks to come. In these circumstances inflation report (within MPC range) went almost unnoticed and did not excite the markets much.

Positive trends in the labor market confirmed. Corporate wages rose by 2.3% y/y in November after a 2.0% rise recorded in October. It has to be noted, however, that the November reading was negatively skewed (downward) by postponed payments of bonuses in mining industry. We estimate that, free of this effects, manufacturing wages might have risen by as much as 5% y/y. As soon as in December (data to be released in January) we may well see the whole aggregate topping 5-6% y/y, which is to be attributed to statistical base effects (bonuses in mining paid in December and low base from 2008 due to economic slowdown). The genuine upward trend on the wages is to be renewed, based on our employment-wages model implied lags, by the end of 2010.

As far as the labor demand is concerned, November saw another stabilization in this field. Not only did annual growth of employment expanded from -2.4% in October to -2.2% in November, but also monthly momentum did prove us right: enterprises shed only 2k job what is inextricably linked to seasonal factors (retail trade, construction). We expect labor market stabilization to continue in the months to come but it is wise to control for “beginning of the year effect” in February, when the Central Statistical Office upgrades the sample and, after a period of economic slowdown, the direction in employment is one-off downward spike (in the vicinity of 30-40k).

Industrial production 9.8% up y/y. GDP to grow by more than 3% y/y in Q4 2009. Industrial output rose by 9.8% y/y in November beating analysts forecasts. Seasonally adjusted figure amounted to +6.8% % vs. 0.6% y/y recorded in October. Today’s reading reflect, however, significant statistical base effects from 2008, when a sudden drop of industrial output occurred and economic slowdown started. Today’s data confirmed strong momentum in Polish industry in Q4. The recovery is genuine and broad based. Rising output has been reported in 26 out of 34 sections. The pace of growth in automotive industry and metal branches accelerated significantly as compared to previous months, which may well be effect of recovering euro area economies.

Inflation rising slowly – 3.7% at the year end within reach. Polish CPI inflation accelerated in November to 3.3% y/y from 3.1% recorded in October (market consensus 3.3%). Monthly growth of prices amounted to 0.3% and reflects acceleration of food prices (+0.7% - perfect match with our model forecasts) and higher fuel prices (+2.4%). As for the core categories there was a drop in communications (-0.4%) and recreation and culture (-0.1%) surrounded by minor increases in lodging, education, hotels and restaurants and “other” category. We expect core inflation to level-off a bit to 2.8% in November from 2.9% in October

Bottom line: inflation reading within the MPC range (and at the end of the MPC tenure) does not excite the markets much. The same is true for the other figures, as we already said in the introduction. It is of utmost importance how will the 2010 look like and whether the U-shaped inflation path (base effects) will be confirmed. We stick to our baseline scenario which will bring a sharp deceleration of CPI at the turn of Q1/Q2 accompanied by a sharp reduction of rate hikes expectations. Thus it may be a good chance to position for the second pat of the year when rising inflation is likely to trigger first rate hikes, especially when decent momentum of the real sphere is likely to add to the potential inflationary environment within the monetary policy horizon.

Polish GDP - an outlook for 2010: The recent data and massive statistical base effect altogether suggest that the Polish economy will enter 2010 with quite a strong momentum. Contrary to 2009 the economy will be driven to a larger extent by domestic demand (see the resilience of the labor market, accelerating infrastructure investment offsetting the decline of private investment demand). We expect the restocking process to neutralize to declining positive net exports contribution. On the supply side, we anticipate improved cost competitiveness of Polish producers being reflected in a genuine recovery of the industrial production. Due to aforementioned infrastructure boom, the construction output is to be on a stable growth path as well. On balance, GDP is going to show a similar growth rates to those in Q4 2009 in the quarters ahead. Our forecast for 2010 growth is thus 3.0% (skewed to the upside).

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.0	4.5
Inflation rate (%, average)	2.4	4.3	3.5	2.3	2.9
Current account (% of GDP, average)	-4.5	-5.3	-1.2	-2.9	-3.7
Unemployment rate (end-of-year)	11.4	9.5	12.0	12.5	10.5
NBP repo rate (end-of-year)	5.00	5.00	3.50	4.00	5.50

Indicator	2009				2010	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	0.8	1.1	1.7	3.2	3.2	2.9
Inflation rate (%, average)	3.2	3.7	3.5	3.5	3.3	2.1
NBP repo rate (end-of-quarter)	3.75	3.50	3.50	3.50	3.50	3.50

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

Fixed Income

Almost Xmas.

Last week we saw again some volatility on the yield curve. Two themes prevailed, constant bid in short end bonds and constant bid in 5y+ IRS. Additionally with WIBOR rates climbing (1M WIBOR is up 20bp from beginning of the month) paying interest on the FRA curve with 3x6 and 6x9 trading some 5bp higher from previous week levels. Last switch bond auction this year went pretty fine (for Ministry of Finance) with total of 1.7 bio bonds sold. At the moment the crucial factor for the market seems to be EURPLN and EURUSD with capital flowing out from Europe. This definitely hurts asset prices in local currencies. Additionally the sentiment worsens over Greece fiscal situations and Austrian's banks problems. Adding to that the lack of liquidity and general attitude towards taking risk over the year end we can say two things. First, our trade idea being long in the outgoing 20y benchmark is now 40 cents underwater and our 2y2y receive position currently standing at 6.23 is 5 bp. under water (we made 3 bp carry as our 2y2y is already 1m shorter than spot one). Second, we are sticking to our view we have been outlining for the past couple of weeks. The feedback we have been getting is generally positive (yes, you may be right, your arguments seem strong) but we have been warned that timing wise our call is a very aggressive one judging the amount of external risks and specific timing of local factors (let's name fear of the supply as the major risk). Well, keeping the faith that Europe will not go bankrupt over New Year and cautiously looking for pitfalls in our scenario, we will stick to what we have. It may not make us money to buy a Xmas gift … but it wasn't the point anyway.

TRADE IDEAS:

Stay long in outgoing 20y benchmark bond (entry 95.60 currently at 95.20, watch stop loss at 94.20), stay receive in 2y2y IRS (entry 6.15 currently at 6.23 (6.20 with carry), watch stop loss at 6.35).

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	1/4/2010	-	4.223%	10/26/2009
2Y T-bond OK0712	1/6/2010	-	5.099%	12/2/2009
5Y T-bond PS0415	1/13/2010	-	5.736%	12/2/2009
10Y T-bond DS1019	1/13/2010	-	6.340%	5/20/2009
20Y T-bond WS0429	1/13/2010	-	6.300%	9/23/2009

Money Market

Cheap carry till the end of the year

Substantial demand for repo despite of the huge cash surplus.

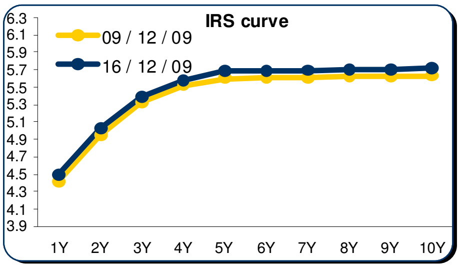
Cheap December became a fact. As we were writing, this month is perceived as a risky one due to the holiday break and the year brake. The nearer the year end the more restricted is liquidity, therefore the reserve is being built in advance and the demand for the money bills is very conservative. The above was also the main reason for quite substantial demand during the NBP 3 and 6M repo auctions. We think that cash was obtained just in case and for the sake of better liquidity ratios.

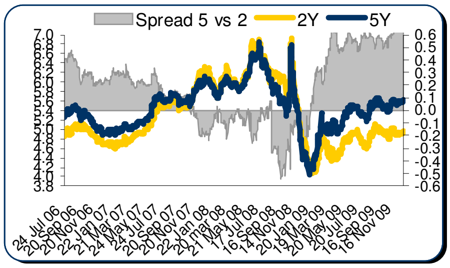
Real economy figures are not likely to thrill the market, and the new MPC is being awaited. It is too early to play on exact timing of the rates hikes. Consensus is for the second half of the next year and this is what all the MM curves reflect.

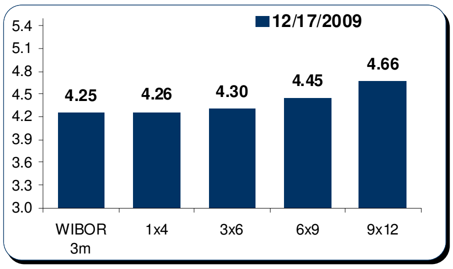
TRADE IDEAS:

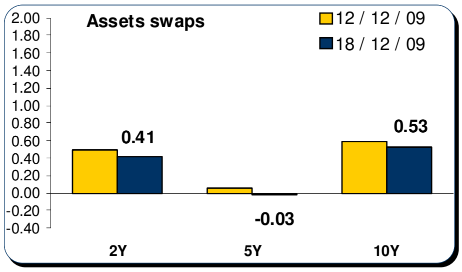
Sell 1Y polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in defense

The strength of the dollar was the main reason behind the EM and Zloty weakness. Of course, it was the USD/PLN cross which has accumulated most of the impact, on the weekly basis the USD/PLN has reached 2.9250 from 2.8000 last Thursday , for EUR/PLN it was the move from 4.1300 to 4.2330 (this week's high). The market is also becoming more and more illiquid due to fast approaching Xmass and the New Year. One can also notice that strong negative correlation between EUR/USD and XXX/PLN has softened somehow.

Implied volatility stable

Volatility curves for EUR/PLN and USD/PLN were quite stable last week, considering the performance of spot. Partially because the good portion of the market participants already have chosen to stay aside till the new year. And all, the Zloty turbulences were translated rather in wider spreads (while zloty was on the retreat), then the actual move of the implied volatility curves.

TRADE IDEAS:

SPOT

Main supports / resistances:
EUR/PLN: 4.1300 / 4.2700
USD/PLN: 2.8000 / 3.0000

Stay aside

Liquidity holes, intraday gaps are the expressions which best describe current pre Xmass market conditions. We suggest to stay aside or assume much wider stop losses than usual, not to get stopped out by same random spot move. In mid/longer terms we are still fundamentally Zloty bulls …..

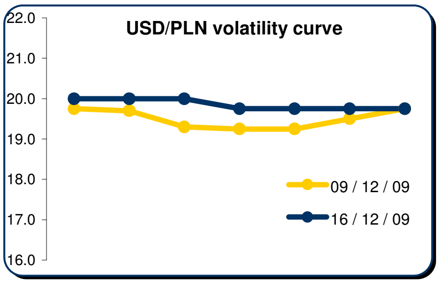
Keep short vega

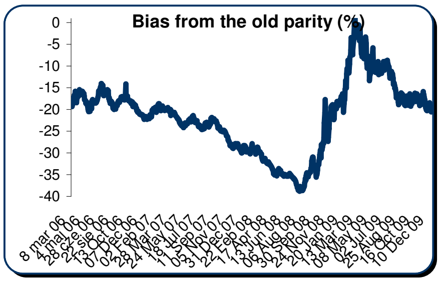
OPTIONS

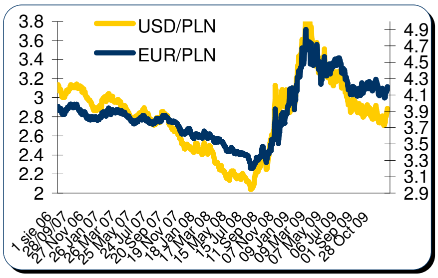
We still feel comfortable with short EUR/PLN Vega as historic volatility supports that view.

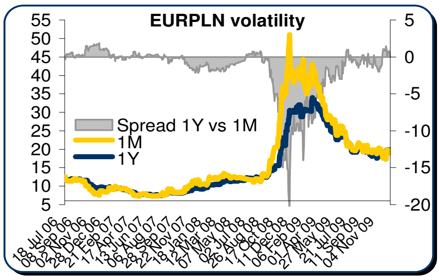
The USD/PLN Vega is another matter, we prefer to be long in longer term Risk Reversals in that cross. To make sure we are long Vanna, and to be on the safe side if the widely predicted dollar driven apocalypse materialize.

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
10/12/09	4.11%	4.20%	4.16%	4.20%	4.37%	4.38%
11/12/09	4.08%	4.21%	4.17%	4.19%	4.35%	6.59%
14/12/09	4.12%	4.23%	4.18%	6.49%	4.38%	4.40%
15/12/09	4.13%	4.23%	4.17%	4.21%	4.37%	4.40%
16/12/09	4.15%	4.25%	4.23%	4.23%	4.42%	4.41%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
10/12/09	4.22%	4.23%	4.39%	4.59%	4.55%
11/12/09	4.20%	4.23%	4.37%	4.59%	4.51%
14/12/09	4.26%	4.25%	4.40%	4.59%	4.57%
15/12/09	4.24%	4.26%	4.40%	4.61%	4.59%
16/12/09	4.24%	4.26%	4.40%	4.62%	4.61%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0709	IRS	PS0511	IRS	DS1017
10/12/09	4.38%	4.15%	4.95%	4.92%	5.61%	5.66%	5.62%	6.23%
11/12/09	6.59%	4.03%	4.96%	4.92%	5.60%	5.65%	5.64%	6.23%
14/12/09	4.40%	4.07%	4.96%	4.91%	5.62%	5.63%	5.64%	6.21%
15/12/09	4.40%	4.07%	4.98%	4.88%	5.64%	5.64%	5.69%	6.22%
16/12/09	4.41%	4.07%	5.02%	4.90%	5.68%	5.65%	5.71%	6.24%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/10/26	10/10/26	95.905	4.22%	500	1758	431
OK0712	09/12/02	12/07/25	87.692	5.10%	5000	5472	1440
PS0414	09/12/02	15/04/25	98.691	5.78%	5000	5614	3629
DS1017	09/04/08	19/10/25	94.460	6.22%	2500	4846	1820

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
10/12/09	19.50	19.50	19.75	19.75	3.25	4.50	0.80	0.85
11/12/09	19.50	19.50	19.75	19.75	3.25	4.50	0.80	0.85
14/12/09	19.50	19.50	19.75	19.75	3.25	4.50	0.80	0.85
15/12/09	19.75	19.50	19.75	19.75	3.25	4.50	0.80	0.85
16/12/09	20.00	19.75	19.75	19.75	3.25	4.50	0.80	0.85

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
10/12/09	2.8168	4.1437	-18.44%
11/12/09	2.8050	4.1390	-19.47%
14/12/09	2.8248	4.1410	-19.84%
15/12/09	2.8635	4.1667	-20.34%
16/12/09	2.8891	4.2028	-20.55%

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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