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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of February 18th 2010 to February 25th 2010

Indicator	Date of release	Pe-riod	BRE forecast	Consen-sus	Last	Comment
Retail sales	Feb 23	Jan	**7.0%**	5.3%	7.2%	Decent growth of auto sales and anecdotal evidence on strong food sales performance. Very strong base effects on fuels and autos. Slight drop of business climate was recorded in sections with a meager contribution to the aggregate.
MPC decision	Feb 24	-	**3.5%**	3.5%	3.5%	First meeting with brand new members (apart from ruling governor Skrzypek) and new inflation projection. Swing voters: Hausner, Zielinska-Głebocka, Gilowska and Chojna-Duch. Watch out for the risk of MPC changing bias at the coming meeting

In Focus / Macroeconomics

Data confirm strong momentum of the economy

This week we had some news on inflation (producer and consumer), balance of payments and the real sphere (labor market, industrial output). Nominal sphere and Polish external position was hardly surprising and we cover them only briefly. It is real sphere which surprised the most and we would like to focus on this topic more thoroughly.

C/A. According to our calculations, current account balance hit 1.5% of GDP lat year. This year we expect the deficit to widen towards 2.3% as the revival of consumption, together with public investment is likely to activate imports. As for now the widening C/A deficit seems negligible for the EURPLN perspectives: it is still healthy financed (170% FDI covering) and the real sphere truly outperforms other CEE economies.

CPI and PPI. Inflation in January hit 3.6% - the data are still provisional and the exact numbers will be announced in March, along with the publication of the new weights in the consumption basket. As for the next months, we may see a significant drop of inflation to 3.0% y/y already in February on base effects from the last year (see a massive zloty depreciation in Q1 2009). This marks the beginning of the U-shaped inflation curve we are likely to see in the coming months (we see the minimum at ca 2.0%) which is likely to lower inflation expectations. The base-effects environment of low consumer inflation will be backed by the very benign behavior of producer prices (we had a third consecutive monthly drop of prices in manufacturing ex energy and the prices in that category are some 5% below the last years level). Harsh battle on competitive advantage is discourages manufacturers from raising prices and this trend is likely to be prolonged in coming months (falling EURPLN may be only a supporter on this field).

Labor market. As for the labor market data, we were very surprised by the data on employment (-1.4% y/y vs market consensus -2.3%). Taken at face value, +50k on monthly basis in the very beginning of economic upturn seems astounding. However, the data is jittered by statistical effects, but in the opposite direction as usual. Normally the period of sharp economic slowdown is followed by the reduction of the number of firms employing more than 9 people. But this time it is different and contrasting with the data on bankruptcies. However, it does not change our fundamental view that labor market is on the rise (increases in some sections of manufacturing in December, upward-sloping business tendency indicators). The true trend will be revealed in February – if we see some rises it will be the sign the recovery is on track and labor market proved extremely resilient.

Turning to corporate wages, January saw lower wage dynamics of 0.5% y/y vs. 6.5% y/y recorded in December. Such a huge drop of growth rate is attributable to two factors: lower number of working days (-2 y/y) and quite common shifting of December wage payment to January (due to tax reasons) in 2009 which created a base effect influencing annual growth. We still expect the next months to display wage growth rates close to 4-5%.
Although the labor market data did not have a direct market impact, they have mid-term potential. Stabilizing labor market is a good sign for budget revenues which should be reflected in lower risk premium included in longer Polish bond yields.

Industrial output. Industrial output also proved much better than expected, despite all headwinds (low temperature, negative divergence of working days). January saw industrial output rising by 8.5% y/y vs. 7.4% recorded in December. The seasonally adjusted numbers are even more impressive – output growth accelerated from 6.3% y/y to 11.1% confirming the strong momentum of manufacturing.

Rising output has been recoded in 22 out of total 34 sections. The annual rate has been in particular boosted by automotive industry (+25.2% y/y), metal industry (25.2%) and electronics (+66%). The breakdown indicates thus rising importance of euro area recovery for the Polish growth trajectory. Turning to short term perspectives, we see Q1 2010 GDP growth exactly as strong as Q4 2009, which we estimate at about 3.0% y/y. The whole year GDP is to grow by about the same rate.

MPC decision. So far the MPC seems to correctly diagnose the shape of short-term inflation outlook. Although some of MPC members may be current data dependent, recent comments (Skrzypek) may suggest the focus may be slowly shifting (quite correctly) to medium-term and upward sloping inflation path (to be presented in the fresh inflation projection). **That is why we perceive the risk of changing the monetary policy bias from neutral to tightening as non-negligible already at the coming meeting.** To this point, recent real sphere data may be nothing but encouraging. As for the direct interest hikes, we think the MPC may embark on a more restrictive monetary policy in H2 as soon as economy proves sufficiently resilient and inflationary pressures begin to mount again (monthly momentum of prices); exact hikes as the uncertainty about economic outlook is still very high, will be preceded by the change of monetary policy bias by some months. Nevertheless, the impact of unexpected change of bias right now would be devastating for the short end of the yield curve.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3+	4.5
Inflation rate (%, average)	2.4	4.3	3.5	2.3	2.9
Current account (% of GDP, average)	-4.5	-5.3	-1.5	-2.3	-3.7
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	4.00	5.50

Indicator	2009				2010	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	0.8	1.1	1.7	3.0	3.8	3.3
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

The words that start with 'P'.

Polish FI market seems to be boxed in a range of 20bp in yield both in 2y and 5y (range between 4.88/5.05 repeated almost again in full last week in 2y and 5.52/5.68 in 5y). The curve between 5y and 10y has steepened some 7bp from last week. Bonds continued to perform well with 5y bond and 2y bonds trading at this year highs in terms of price. 10y bonds are definitely underperforming the rest of the curve. The spread to euro is stable currently trading close to 143 bp over respective IRS. If we were to look for reason of such a development it will definitely be Greece factor (or brother PIIGS effect). Data from local economy seems to be supporting our view about economy rebalancing very quickly (employment up, industrial output up, PPI down, CPI modest growth). Supply is making no impact on the bonds market so far (issuance is close to 50 bio) and prices of bonds are still going higher (apart from the 10y sector). It may sound a bit boring as we keep repeating our view for a while right now, but we see no reason, nor we have any evidence that would prove us wrong. We are getting closer to the moment where the trend in **falling CPI will be more visible together with very impressive GDP growth, Ministry of Finance will secure close to 50% of their borrowing needs most likely in March, RPP may decide to change bias to restrictive due to new CPI and GDP projection**. This may lead to some serious strengthening of EURPLN as well as curve significant flattening in 5y10y year area, but also steepening in the FRA spreads. With current market dynamics the view would be reflected in lower yields of longer bonds as well as dropping 2y2y IRS. We also see FRA spread between 3x9 and 6x12 to widen.

The fashion right now though is to play the "safer bet", to play deconvergence, Poland may be next Portugal, after all both words start with "P".

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	3/1/2010	-	3.844%	2/8/2010
2Y T-bond OK0712	3/10/2010	-	4.972%	2/10/2010
5Y T-bond PS0415	3/10/2010	-	5.736%	12/2/2009
10Y T-bond DS1019	3/17/2010	-	6.103%	2/19/2010
20Y T-bond WS0429	3/17/2010	-	6.170%	9/23/2009

Money Market

Short term depo slightly below 3%

Last Friday Central Bank again offered the amount of 7-day bills that made the market square. Banks bought all PLN 69 bln bills (the biggest amount ever) and there was even small reduction rate of 5.91%. As a result short term depo rates were slightly below 3% this week. Next week will be the last one in this reserve requirement period that is why we would expect banks to participate in tomorrow's OMO with cautiousness.

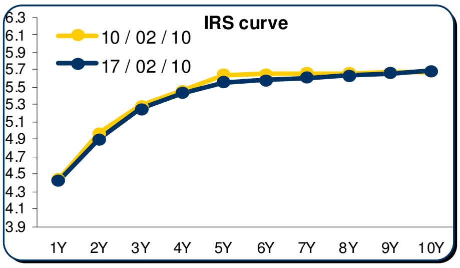
Average 6M repo yield up by 9 bps

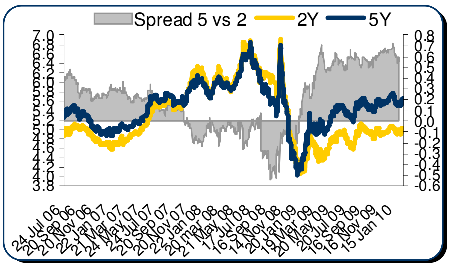
On Tuesday NBP offered 6M repo collateralized in PLN. It was second repo tender with limited offer. Central Bank pool was PLN 100 mln which covered maturing PLN 67 mln from previous repo. Banks bidded PLN 150 mln but NBP accepted only PLN 100 mln at an av. yield 3.94%. Limited pool forced banks to increase the repo rates on average by 9 bps in comparison to last month.

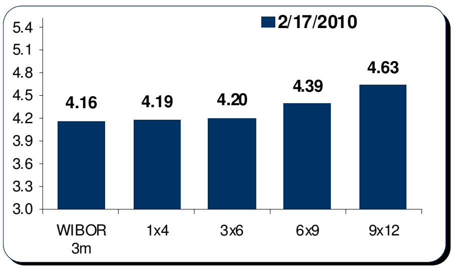
Tbills yields down at the tender

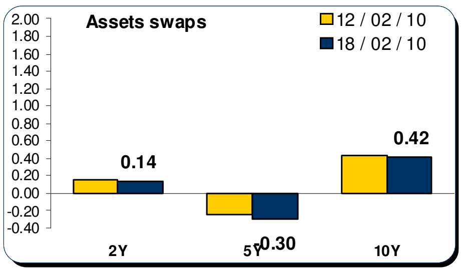
On Monday MinFin offered 52-week tbills. Banks demand was almost 3 bln PLN and MinFin sold PLN 952 million bills at an av. yield 3.844% (against 3.851% last week).

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Euro zone members "agreement on Greece" has dominated zloty trading last week. As Greek's woes has faded, Zloty was one of well bid currencies. We have started the week with 4.0350 top and traded down to 3.9700 bottom. EURPLN is still well correlated wit EURUSD, now -0.65 against -0.35 before Greek crisis. Because of that, the current EURUSD selloff took EURPLN back higher to 4.00. The big question mark is a behaviour of Polish exporters, who may be starting to feel the heat of the gradually stronger Zloty and try to hedge their exposure, selling hard currency on the market .

Implied volatility lower

Thaw on global sentiment combined with quiet price action has pressured the volatility curve lower, especially the short end. 1M was traded at 11.75% in comparison to 12.5% previous week, 1Y respectively 12.5% and 12.8%. USDPLN volatility curve is more volatile and interesting. We have observed both, bit better liquidity and higher correlation with EURUSD curve's shape (0.85 as against to 0.65 at beginning of February). Range of USDPLN 1year ATM volatility trading was 18.15% -19.05%, so 0.9% in comparison to EURPLN's 0.3% (!) .

Short-term foracasts

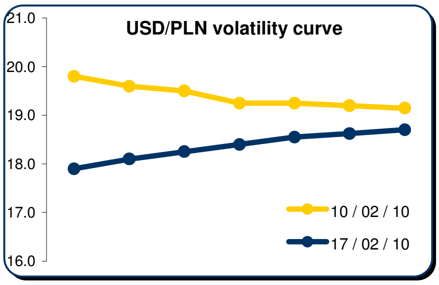
SPOT

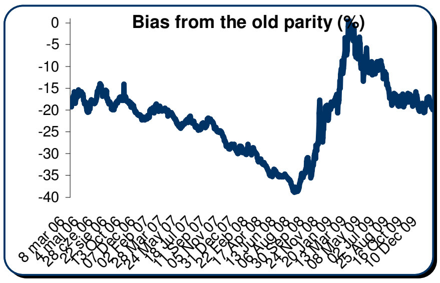
Main supports / resistances:
EUR/PLN: 3.9500 / 4.1600
USD/PLN: 2.8700 / 3.0000

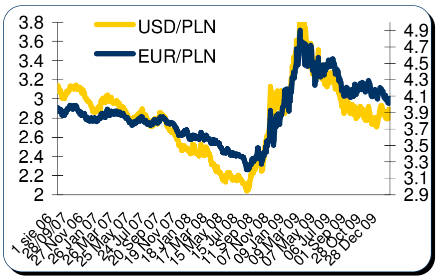
We are still Zloty bulls because of the strong macroeconomic fundamentals, wait for the decisive break of 3.9500.

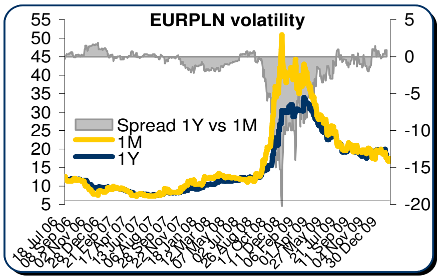
OPTIONS
Zloty is getting stronger, but the external risk remains. Implied volatility should be range bound. 3M-6M tenors as the most liquid, the most transparent. Despite lower spot, long end remains well bid.

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
11/02/10	4.10%	4.19%	4.10%	4.18%	4.30%	4.40%
12/02/10	4.07%	4.17%	4.20%	4.17%	4.35%	6.59%
15/02/10	4.10%	4.17%	4.15%	6.49%	4.35%	4.37%
16/02/10	4.04%	4.18%	4.15%	4.17%	4.35%	4.37%
17/02/10	4.08%	4.16%	4.14%	4.16%	4.33%	4.37%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
11/02/10	4.20%	4.25%	4.44%	4.70%	4.63%
12/02/10	4.22%	4.25%	4.43%	4.71%	4.62%
15/02/10	4.17%	4.23%	4.42%	4.67%	4.62%
16/02/10	4.17%	4.21%	4.41%	4.66%	4.60%
17/02/10	4.21%	4.22%	4.41%	4.66%	4.59%

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
11/02/10	4.40%	3.67%	4.95%	4.63%	5.55%	5.29%	5.68%	6.10%
12/02/10	6.59%	3.65%	4.92%	4.60%	5.53%	5.29%	5.67%	6.11%
15/02/10	4.37%	3.65%	4.93%	4.57%	5.55%	5.28%	5.70%	6.11%
16/02/10	4.37%	3.64%	4.95%	4.59%	5.57%	5.28%	5.71%	6.11%
17/02/10	4.37%	3.64%	4.90%	4.56%	5.55%	5.25%	5.68%	6.10%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/02/08	11/02/08	96.252	3.85%	1200	3134	1090
OK0712	10/02/10	12/07/25	88.795	4.97%	5500	12417	5500
PS0415	09/12/02	15/04/25	98.691	5.78%	5000	5614	3629
DS1019	10/02/19	19/04/25	95.629	6.10%	2000	5570	2000

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
11/02/10	18.35	18.65	18.90	19.00	2.25	3.75	0.60	0.90
12/02/10	18.10	18.40	18.55	18.70	2.25	3.75	0.60	0.90
15/02/10	18.10	18.40	18.55	18.70	2.25	3.75	0.60	0.90
16/02/10	17.90	18.25	18.45	18.55	2.25	3.75	0.60	0.90
17/02/10	17.65	18.00	18.20	18.30	2.00	3.65	0.60	0.90

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
11/02/10	2.9503	4.0548	-18.68%
12/02/10	2.9503	4.0035	-19.45%
15/02/10	2.9503	4.0227	-19.91%
16/02/10	2.9503	4.0168	-20.46%
17/02/10	2.9503	3.9878	-19.12%

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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