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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, MARCH 4, 2010

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of March 5th 2010 to March 11th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
NO SIGNIFICANT RELEASES						

In Focus / Macroeconomics

Polish PMI shoot up in February

In February Polish PMI rose to 52.4pts after it recorded an unexpected drop to 51.0pts in January. Index provider – Markit Economics – pointed to a stronger momentum in manufacturing in February listing accelerating production, rising new domestic and exports orders. Going into more details, capital goods orders increased at the highest pace since March 2008 (extending thereby the trend in hard data) .

These overoptimistic assessments contrast with the employment subindex. Employment has been – with exception of a brief revival in December – contracting since May 2008. It has to be noted however, that the pace of contraction slowed significantly in February. Subdued employment readings are not a reason to worry at this point. It is no more than a typical behavior of the index in the early recovery phase of the business cycle.

Markit Economics suggested further that although PMI subindices topped their long term averages, Polish manufacturing is continuously plagued by low capacity utilization, which is attributable to the economic slowdown in 2008 and 2009. The price pressure is thus subdued; in February prices dropped even by more than in January. Turning to competitiveness issues, some companies noted that they had to lower exports prices due to stronger zloty. This notion is to gain on importance going forward for at least two reasons. Firstly, as the MPC seems to be more and more zloty-centric and does not welcome any deterioration of the competitiveness of the Polish exporters it may ultimately delay interest rate hikes. Secondly, Polish corporates fearing stronger zloty may be now more active hedging their foreign currency flows, which historically proved to be one of the key reason for zloty overshooting.

3.1% GDP growth in Q4 confirmed

Official release of Q4 GDP data confirmed what could have been extracted form annual data. GDP grew by 3.1% y/y and recorded quite solid 1.2% q/q on seasonally adjusted basis.

Taking apart the GDP growth from demand side we saw w 2.0% y/y increase in private consumption accompanied by a growth of fixe business capital formation of 1.6% y/y (quite meaningful figure compared with 1.5% fall recorded in previous quarter). We observed relatively high net exports (+2.2pp.) and a turnaround in the change-of-inventories contribution towards -0.2pp. As for the latter figure, the nominal amount of change in inventories was negative, close to the level recorded in Q1. It bodes well for future contributions of restocking as there is still much space to be close to the desired level of inventories. Analysis from the supply side shows acceleration of gross value added in industry (from -0.2% y/y to 5.6% y/y), stabilization of VA in market services (2.2% y/y) and a fall of VA in construction (from 7.2% to 3.4%).

As for the perspectives for the coming quarters, we uphold our view that recent tendencies will be left intact. We expect the GDP growth in Q1 to be close to the one recorded in Q4. To be more specific, such a rationale is supported by the latest results of industrial production (growth rate on average close to the one in Q4, lower contribution of net exports likely to be at least partially offset by further statistical effects in inventory formation). As for the whole year, we expect the growth rate of investment to reach 3-4% (however, watch Q1 in which – due to seasonal anomalies – fixed business investment may be under water again). At least stabilization should occur on the private consumption side (2-3% growth rate in coming quarters); we expect changes in the labor market to positively influence the propensity to consume out of income (standard measure) but also from credit; one may expect a positive influence owing the public infrastructure investment. And again, lower contribution of net export will be offset by restocking.

Hawkish Skrzypek. Oxymoron?

Recently we observed something which had never happened before. **Governor Skrzypek uttered not only the most hawkish comments in the whole MPC but also one of the most rational and forward looking.** Here are some thoughts concerning Skrzypek's hawkishness on the background of other factor influencing the MPC behavior.

- Skrzypek suggested lately the MPC should start “thinking” about rising rates on the back of inflation rising above the target in 2012. However, such a statement is nothing new (to be precise it is the third occurrence, the first was before the February meeting…and nothing happened).
- Skrzypek believes in stability of the exchange rate (it would be then hard to reconcile with fur-

ther talking of rate hikes; MPC members would soon notice their talk is strengthening the Zloty, hampering GDP growth…).
- Apart from mentioning the need of MPC to "start thinking…" Skrzypek also underlines the risk factors, centered around the global economy and the strength on the ongoing recovery (this line of thought is more than ever exploited by the dovish camp, lately Kazimierczak).

…and some further background:

- Zloty around 3.90, coming close to pain threshold for exporters, who already lowered the prices to preserve competitiveness (see the details on PMI survey).
- Regarded as a new swing voter Hausner seems extremely risk averse (on the conduct of monetary policy his official response is "hard to say", on the other hand he speaks eagerly on fiscal policy…) and would rather prefer waiting.
- Falling inflation in coming months is likely to encourage other rate-setters to wait, exploiting the possibility of supporting GDP growth (as a side-product of allegedly achieved price stability).
- **We stick to our assessment that changing the monetary policy bias <u>was most appropriate in February.</u> One cannot rule out that a "human factor" was at work back then – February meeting was the first to be attended by the brand new MPC. Some of them may not have been ready enough to make binding decisions (see also their preferred set of interests including zloty stabilization, economic policy). <u>Regardless of how strange this would be markets should be aware of the ongoing risk of the bias change.</u>**

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	3.1	**3.0**↓	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

Who is who?

Last week we saw good activity on the market. The curve remained in a range of 2y and 5y trading between 4.90/5.00 and 5.52/5.62 respectively, 5y10y spread widen back to 17 bp. The switch auction yet again brought very good interest with Ministry of Finance selling more than 4.7 bio of long end bonds at relatively high prices. 5y5y forward widen to 155 bp over euro, ASW on the other hand have tightened some 5-7 bp across the curve, with 10y bonds making the biggest move. The bond curve has actually flattened with long end bonds clearly outperforming short end bonds for yet another week. The biggest impact on the market though, (finally) had comment (repeated 3 times if we are correct) by governor Skrzypek, who said that RPP should consider rate hike. Our call about the bias change did not happen at last RPP meeting, but the influence made by the above comment (neglected by market for sometime) had pretty much the same effect. The FRA curve has steepened with 9x12 trading at 4.70 (10 bp higher), the pressure on the front end bonds seems to be gaining momentum, as they are (in our opinion) expensive, and also overcrowded. Our view is that monetary policy can take a central stage right now. We don't think that market has a good feel about new RPP squad, the division between hawks/doves can be misleading (comments from Glapinski and Skrzypek suggesting higher rates trajectory especially in the near term … doves?). In our opinion such statements create opportunity for further steepening of the FRA curve as well as liquidation on the "carry trades", even despite lower (but expected) CPI path. The factor that should be watched is closing the output gap (already suggesting CPI breaching higher band of the NBP target). Risk of the bias change is on the table.

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	-	3.856%	2/22/2010
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

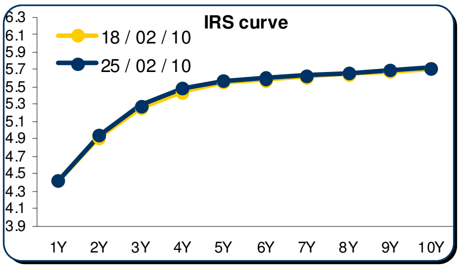
Market disturbance made by insufficient credit lines

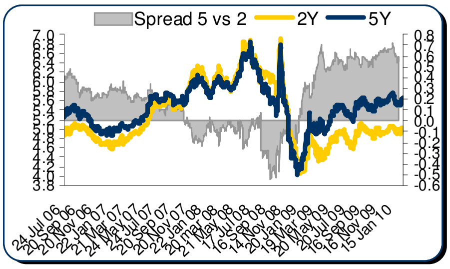
Stronger currency support the doves

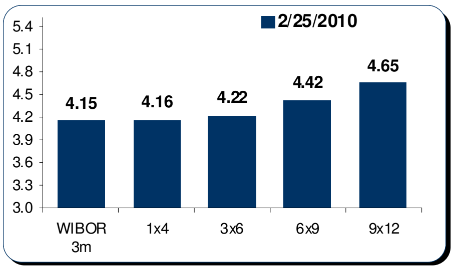
Stable start of the new reserve settlement period with the cost of carry nearby 3%. Since we could observe some bids above the offers for ON deposits, we can conclude that along with the growing market liquidity there is also grow in the asymmetry of the liquidity layout, as far as the whole system is concerned. This could be confusing for some market participants since direct trades are off the official market seen on the brokers screens. However, it looks like we have to either get used to similar situations or push for higher credit lines.

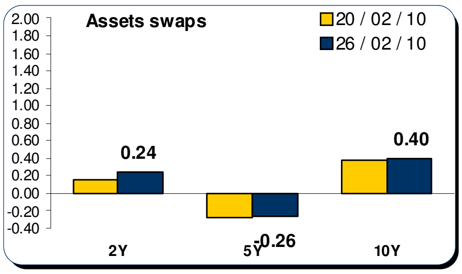
Stronger currency is a good balance for the faster then expected (autumn) rates hikes scenarios. We still think that the MPC can start tightening no sooner then in 3rd quarter.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Good investment sentiment lasts. While risk has been well priced Poland announced good-as-expected GDP numbers what attracted more PLN buyers, mostly abroad funds. Zloty strengthened to 3.8950 to EUR and 2.8350 to USD. Although positioning seems a bit crowded, market trust this move so PLN is gaining slowly but gently.

Implied volatility lower

One sided, gradual EURPLN move translates into lowering realized volatility. Last week one's was 4.8% what in comparison to 1W traded at 10.0 (11.0 week ago) still looks attractive. Other tenors were traded at: 1M 10.2 (10.6 last week), 1Y 11.8 (12.1). Currency spread EURPLN vs. USDPLN was traded at 5.75 what, in relation to 6.5 – Greece crisis level, prices lower correlation EURPLN vs. EURUSD in coming days.

<u>Short-term forecasts</u>

SPOT

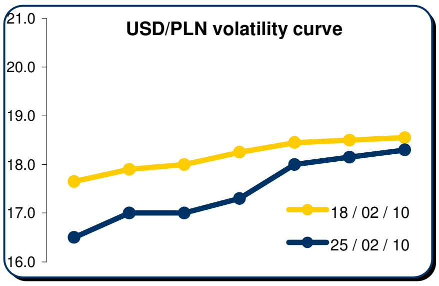
Main supports / resistances:
EUR/PLN: 3.8875 / 4.0500
USD/PLN: 2.8200 / 3.0000

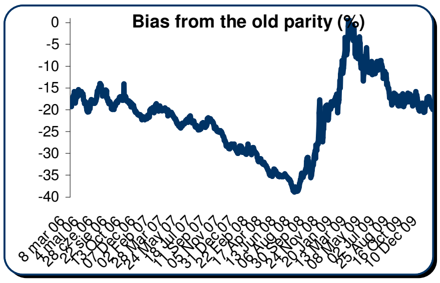
The range of possible correction is now 4.05. In the longer-term we remain zloty bulls.

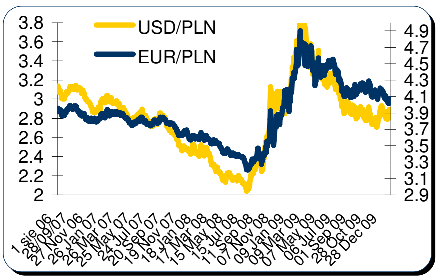
OPTIONS

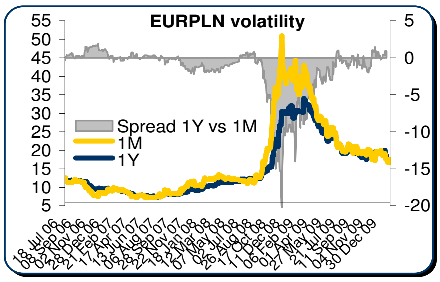
EURPLN spot market strengthen slowly, it is still good time for playing vols range by long vanna. Good tenors are 3M-6M as the most liquid and transparent. Short vega is good idea for the ones expecting higher spot.

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
19/02/10	4.04%	4.16%	4.18%	4.16%	4.36%	4.36%
22/02/10	4.08%	4.16%	4.12%	4.15%	4.34%	6.59%
23/02/10	4.10%	4.15%	4.13%	6.49%	4.34%	4.35%
24/02/10	4.00%	4.15%	4.15%	4.15%	4.35%	4.35%
25/02/10	4.01%	4.15%	4.10%	4.13%	4.32%	4.34%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
19/02/10	4.17%	4.22%	4.41%	4.65%	4.60%
22/02/10	4.19%	4.20%	4.39%	4.63%	4.58%
23/02/10	4.19%	4.22%	4.41%	4.65%	4.58%
24/02/10	4.19%	4.21%	4.42%	4.66%	4.60%
25/02/10	4.16%	4.22%	4.41%	4.65%	4.58%

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
19/02/10	4.36%	3.62%	4.95%	4.60%	5.57%	5.29%	5.72%	6.10%
22/02/10	6.59%	3.62%	4.92%	4.60%	5.55%	5.27%	5.71%	6.08%
23/02/10	4.35%	3.62%	4.95%	4.60%	5.57%	5.24%	5.70%	6.06%
24/02/10	4.35%	3.62%	4.98%	4.64%	5.58%	5.24%	5.68%	6.05%
25/02/10	4.34%	3.62%	4.94%	4.66%	5.57%	5.31%	5.72%	6.12%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/02/22	11/02/22	96.238	3.86%	1800	3920	1800
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
19/02/10	17.65	18.00	18.20	18.30	2.00	3.60	0.60	0.90
22/02/10	17.65	18.00	18.20	18.30	2.00	3.60	0.60	0.90
23/02/10	17.00	17.30	18.00	18.30	2.00	3.65	0.60	0.90
24/02/10	17.35	17.65	18.15	18.35	2.50	3.65	0.60	0.90
25/02/10	17.35	17.65	18.15	18.35	2.50	3.65	0.60	0.90

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
19/02/10	2.9658	4.0031	-17.39%
22/02/10	2.9166	3.9711	-17.81%
23/02/10	2.9040	3.9630	-18.27%
24/02/10	2.9570	4.0015	-18.28%
25/02/10	2.9601	3.9933	-18.97%

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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