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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of April 14th 2010 to May 20th 2010

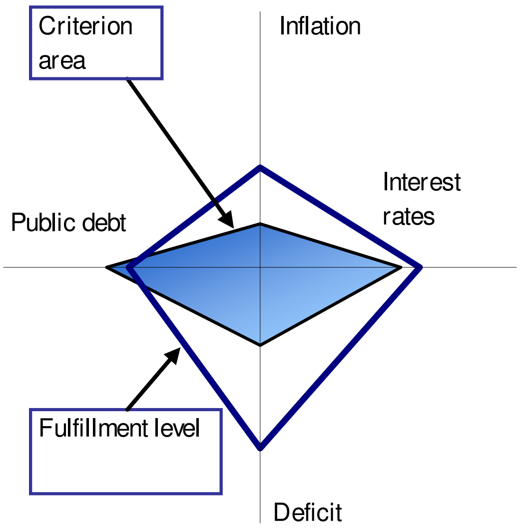
Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
CPI Inflation y/y	May 14	Mar	**2.1-2.2%**	2.2%	2.6%	Fuel prices rising, low growth of food prices (0.5% m/m). Core inflation at 1.6% y/y.
M3 Supply y/y	May 14	Apr	**5.1%**	6.6%	5.6%	Repo balance lower by PLN 5bn. More deposits (institutions) connected with PZU's IPO.
C/A balance EUR	May 17	Apr	**-891mln**	-543mln	+106mln	Wider trade gap at EUR -650mln. Solid growth rate of exports and imports. Highly negative income account, lower surplus in current transfers.
Wages y/y	May 17	Apr	**4.9%**	4.0%	4.8%	Accelerating growth of wages in manufacturing. No difference in working days.
Employment y/y	May 17	Apr	**-0.2%**	-0.2%	-0.6%	Growth of employment of 3-6k on monthly basis. A fact of definitely lower unemployment rate in April (12.3% - as quoted by the Ministry of Labor).
Producer prices y/y	May 19	Apr	**-1.1%**	-1.4%	-2.4%	Higher prices of oil, copper and PLN depreciation. Price expectations rising.
Industrial output y/y	May 19	Apr	**11.6%**	10.4%	12.4%	No difference in working days. Low base effect from April 2009. Solid growth of industrial output in German economy gains momentum.

In Focus / Macroeconomics

Polish euro zone entry off the agenda at the moment

Yesterday, Estonia was given green light for entering euro zone in 2011. There are no doubts as for fulfilling Maastricht criteria (the country proved to be effective in implementing fiscal austerities even when economy plunged 14% in 2009; however, owing to the temporary origin of the cuts, fiscal adjustment will be closely monitored in the future) and joining EMU seemed a natural step forwards after thriving in currency board with the euro for years. There are some arguments that the parity exchange rate (15.6 local currency units for euro) will add to pressured competitiveness of Estonian goods, and flatten further the recovery path. However, Estonia seems such a small country (less than 0.2% of EMU16 in terms of GDP) that even in the light of problems faced by the last newcomers (especially Greece, Spain and Portugal), the risk is truly negligible and the enlargement itself positive for supporting the idea of economic integration at least politically.

In normal circumstances, new and successful entrance warms up discussion concerning the other candidates. This was not the case this time. After in late 2008 PM Tusk announced Poland's EMU entry in 2012, the chances for this to happen have been gradually fading. The more so since Poland does not fulfill 3 out of 4 Maastricht criteria (see the graph below; the only issue Poland is not underwater is public debt criterion) as was officially (not for the first time in recent months) announced yesterday. It seems the only place the euro issues are playing important part are the NBP premises, where MPC resides.



After the MPC was remodeled at the beginning of 2010, we hear more from rate-setters about the possible dates of eurozone entering (continuously seen as a necessity and something unconditionally positive for the Polish economy) than about the issues connected with the conduct of current monetary policy. So far the MPC is unanimously supporting GDP growth and concentrates on the exchange rate stability to prevent the zloty from significant appreciation (in order to support exports). As for the mentioned dates of EMU accession, there seems to be consensus (among, of course, the "governmental part" of the MPC) for 2015. Although governmental sources continuously stress that euro adoption is one of the strategic goals, given the fading social support for the agenda and quite adverse developments in the euro area PM Tusk's top aide Dr. Boni rather quote 2017 as the earliest possible accession date. The government-quoted date seems to be more reasonable to follow then. Indeed the majority of factors speak in favor of later accession and for convergence spreads to remain wide for 2010-2011 at least.

1) There is little chance that Poland will meet convergence criteria soon. As for inflation there is somehow a consensus (among MPC members) it is going to stay at a moderate level, allowing the convergence criterion in this field to be met in a short time in the future. However, the diver-

gence in growth rates between Poland and EMU rather do not make such a scenario more probable, the same applies to observed inflation trends (MPC being against zloty appreciation and thus slowly falling behind the curve only adds to the inflationary picture, recession in the EMU peripherals on the other hand speaks for lower euro area inflation). Secondly, there is a risk that fiscal consolidation in Poland will be effectively postponed owing to political calendar (parliamentary elections in 2011). **We think that at some point investors may flunk Polish consolidation program, contrasting it with that of the EMU periphery countries which *actually* committed to large fiscal cuts.** Although rising Polish GDP and overwhelmingly positive sentiment towards Polish assets are unquestionable, the adverse fiscal scenario is a medium to long term risk and should be reflected at least in the shape of Polish yield curve.

2) Not once did Tusk show that his government official line is sensitive to public opinion polls. Since the society seems not so much in favor for fast EMU accession, such a line of thought should be followed by the government (and indeed it is, euro zone is neither the priority nor in the agenda right now), at least until 2011 elections (but from the on, the problem of fiscal adjustment returns).

3) For some time Polish euro-enthusiastic officials seemed to follow the line of thought that Poland is somehow deemed to entering euro zone. Such a reasoning coined some urban legends as if euro zone accession criteria may be temporary loosened as to allow the "stars" of CEE to enter fast and reap all the alleged benefits (as this is a whole different story we do not cover this in this issue of weekly report). After recent periphery-connected events one may have an impression that such a form of entering really could not have been allowed by the Commission, and it will not be in the future. Moreover, there is a wide discussion concerning the strengthening of the Maastricht criteria and imposing more restrictive sanctions for violations (at the moment there are rumors it mat concern limited the access of violator to EU funds, mostly structural). It is highly unlikely then that Polish officials would like to trade EU funds for EMU membership, especially taking into account the historical problems with putting reins on fiscal spending.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.5	4.5
Inflation rate (%, average)	2.4	4.3	3.5	2.3	2.9
Current account (% of GDP, average)	-4.5	-5.3	-1.6	-2.7	-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	3.5	3.6
Inflation rate (%, average)	3.2	3.7	3.5	3.3	3.0	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

EU to the rescue, but the problems remain.

Last week we had nice volatility on the FI market. On Friday everything looked very messy and awful. EURPLN rate was climbing towards 4.25, and Polish bonds selling off quite heavily (PS0415 trading down at 100.20) and 2y IRS at 4.70. Monday brought a big relief; EU to the rescue and everything rallied (almost everything). Bonds became very well bid, with auction clearing 130 cents higher than Friday close, 2y IRS traded at 4.40 as the low. But, long end bonds and unperformed heavily rest or the curve. 2y10y spread traded as high as 105 points. So it looks like market is pricing (fairly enough) some rough times in the future. It can be either risk of **RPP falling back behind the curve** (intervention and rate cuts talks did some damage) or **fiscal problems down the road**. In these circumstances, the Fact that each of the current RPP is **saying zero about the CPI**, but they spent a lot of time arguing FCL, NBP profit, EURPLN exchange is definitely not encouraging. Next month we will have another CPI projection, which can (should) get bigger attention after all. Ministry of Finance on the other hand secured half of their borrowing needs, it is also true that privatization is going well and 25 bio target is secured, but **what is actually needed to preserve excellent sentient that Polish bonds are enjoying right now are structural reforms.** Looking at the calendar and election polls we think that rightly some risk premium should be build into the curve. Steeper curve reflects that and we see risk of further steepening of the curve, we also would like to see ASW widening from current levels. As far as market we think that we are boxed in range in 2y IRS between 4.40 and 4.70, we also see potential for further steepening of the curve.

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	5/17/2010	-	3.720%	5/10/2010
2Y T-bond OK0712	6/2/2010	-	4.802%	5/5/2010
5Y T-bond PS0415	7/14/2010	-	5.156%	5/12/2010
10Y T-bond DS1019	6/16/2010	-	5.586%	4/14/2010
20Y T-bond WS0429	6/16/2010	-	6.170%	9/23/2009

Money Market

Relatively high cost of carry

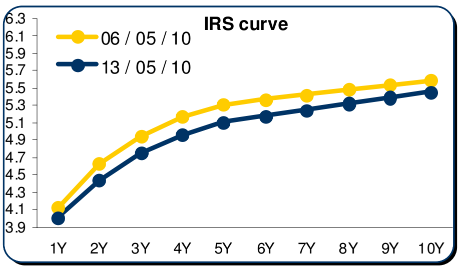
Pro forma repo auction

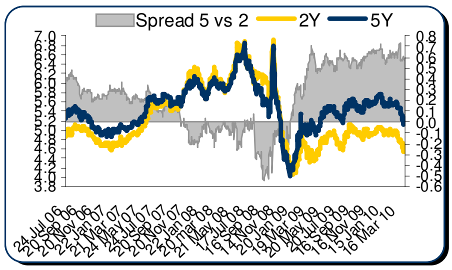
EU and IMF rescue successful as of now

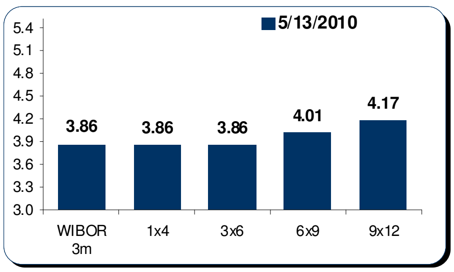
Quite an odd week as far as liquidity is concerned. Despite the PLN 4.5 billion of the excess cash in the system, polonia index was well above 3%. No logical explanation to that, we can only guess that someone needed higher fixings and was keeping the market bids high (mainly one bank on the bid and finite credit lines are sufficient to achieve this goal short term). However, the more expensive is now with such a surplus, the higher probability for prolonged cheap end of the reserve period.

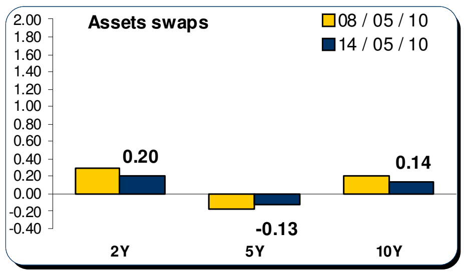
3M repo auction was just a pro forma one. Extremely small supply was not even matched (PLN 250 mln offer and 228 mln demand). It proves that overall system liquidity is still growing. EU and IMF rescue plan details were announced on Sunday and starting from Monday markets were crazy in a bullish sense. Short-term the aim is enough. However, to keep the positive sentiment some real moves on the fiscal side of the threatened countries are a must.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Not emergency aid but systematic solution, this was the message The European Commission has announced to financial markets during last weekend. Market response was really enthusiastic! After previous (6th/7th of May) Thursday's/Friday's EURPLN high at 4.2350/4.2400 and 4.1500 as week close, cross opened on Monday at 4.0400 and has been traded on Zloty stronger side. Thursday's low below 3.95 took rate to level where the story, on 4th May, has begun. Correlation with EURUSD, so commonly traded, decreased form -0.9 to -0.4 in week measure terms. Or to display it more clearly, whilst EURPLN gained 6%, EURUSD cross is still traded around 1.26-1.27 levels.

Implied volatility lower from highs

Two numbers are undisputed to start this story: 40% for EURPLN and 57% for USDPLN were 03-07 May realized volatility levels. Implied vols have never been there…This week's Zloty strengthening, in spite of its rapidness (EURPLN realized volatility 21%), took implied curve lower: EURPLN's1M from 16.5% down to 13.0, 1Y from 14.5 down to 12.0. EURPLN smile reacted similarly with benchmark 3M RR traded from 5.0 down to 3.5. On the other hand, despite lowering correlation with EURUSD, USDPLN vs EURPLN currency spread is still traded at 7% level.

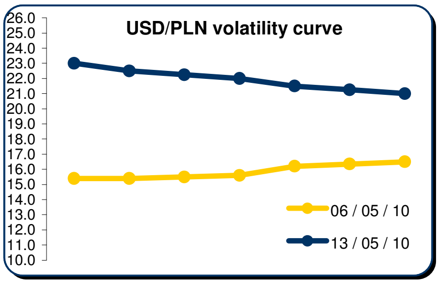
Short-term forecasts

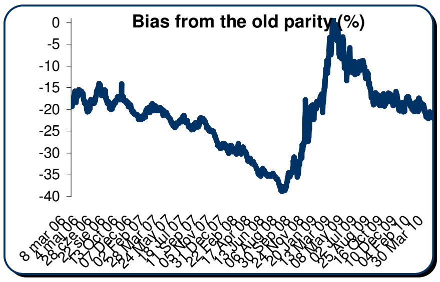
SPOT
Main supports / resistances:
EUR/PLN: 3.9000 / 4.1200
USD/PLN: 3.0200 / 3.2000

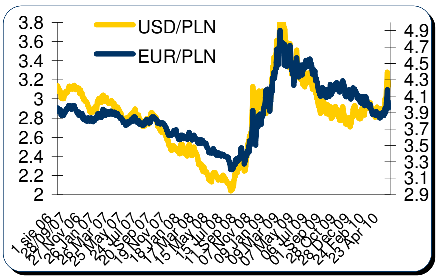
We expect some consolidation from the last week, wild swings. We believe that, potential NBP bids should create the floor for the EUR/PLN around 3.8500 , and from the upside 4.1200 seems currently a strong resistance. We have to bear in mind that despite the solid Polish fundamentals, Zloty is a hostage to the global sentiment.

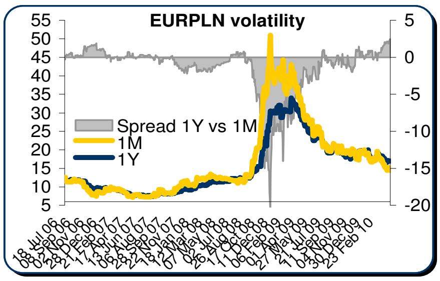
OPTIONS
The long Gamma was the priceless asset, during last week. And the price action on implied volatility was really brutal (1 year EUR/PLN was taken on Friday at 14.50% only to get given on Monday at 12.50%). Within some time volatility is going to slowly fade. However, currently it is good option to make use of a wider range.

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
07/05/10	3.77%	3.86%	3.95%	3.92%	4.18%	4.16%
10/05/10	3.77%	3.87%	3.95%	3.92%	4.20%	6.59%
11/05/10	3.79%	3.87%	3.88%	6.49%	4.13%	4.18%
12/05/10	3.78%	3.86%	3.88%	3.92%	4.14%	4.17%
13/05/10	3.78%	3.86%	3.90%	3.92%	4.15%	4.17%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
07/05/10	3.85%	3.91%	4.04%	4.32%	4.30%
10/05/10	3.90%	3.91%	4.05%	4.31%	4.30%
11/05/10	3.86%	3.89%	4.04%	4.30%	4.28%
12/05/10	3.85%	3.90%	4.06%	4.35%	4.30%
13/05/10	3.87%	3.87%	3.96%	4.24%	4.20%

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
07/05/10	4.16%	3.84%	4.68%	4.39%	5.40%	5.23%	5.66%	5.86%
10/05/10	6.59%	3.74%	4.50%	4.21%	5.19%	5.03%	5.45%	5.61%
11/05/10	4.18%	3.73%	4.47%	4.21%	5.14%	4.98%	5.43%	5.60%
12/05/10	4.17%	3.71%	4.44%	4.21%	5.11%	4.98%	5.46%	5.60%
13/05/10	4.17%	3.71%	4.44%	4.21%	5.11%	4.98%	5.46%	5.60%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/04/19	11/04/19	96.341	3.76%	800	3941	750
OK0712	10/04/07	12/07/25	89.301	4.54%	3000	6726	2999
PS0415	09/04/21	15/04/25	102.209	4.99%	3000	6623	3000
DS1019	10/04/14	19/04/25	97.311	5.59%	3500	7980	3505

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
07/05/10	22.50	22.00	21.50	21.00	4.25	5.00	0.70	0.95
10/05/10	21.50	20.75	20.50	20.00	4.00	4.75	0.70	0.95
11/05/10	21.00	20.00	19.75	19.50	3.75	4.50	0.70	0.90
12/05/10	20.50	19.50	19.25	19.00	3.75	4.50	0.70	0.90
13/05/10	19.50	18.85	18.65	18.50	3.50	4.35	0.70	0.90

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
07/05/10	3.2808	4.1770	-20.75%
10/05/10	3.0667	3.9998	-20.89%
11/05/10	3.1888	4.0441	-20.55%
12/05/10	3.1356	3.9900	-18.89%
13/05/10	3.1473	3.9591	-19.80%

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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