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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, MAY 21, 2010

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of April 21st 2010 to May 28th 2010

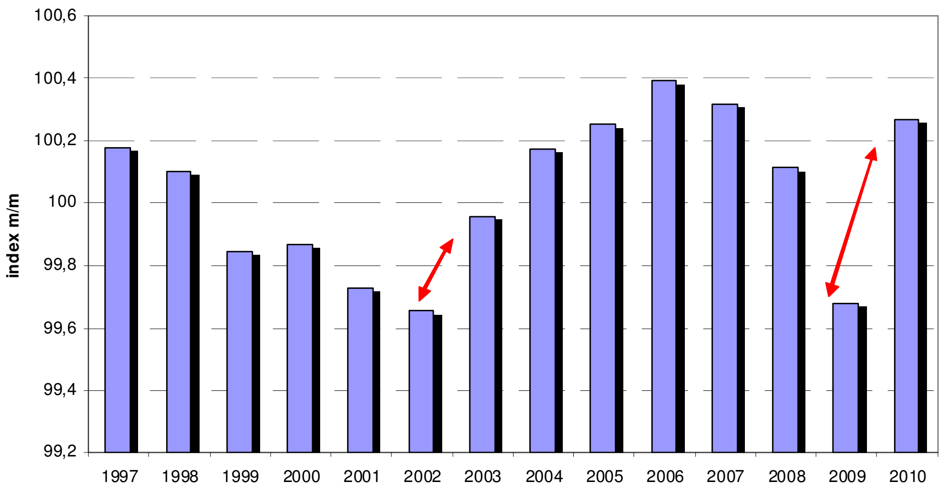
Indicator	Date of release	Pe-riod	BRE forecast	Consen-sus	Last	Comment
Core inflation y/y	May 21	Apr	**1.8%**	1.8%	2.0%	Some upward, surprising movement in tobacco and wearing apparel.
Retail sales y/y	May 26	Apr	**0.8%**	3.8%	8.7%	National mourning effect, after Easter sales effect, base effects from the last year. Significant drop in auto sales.

In Focus / Macroeconomics

Higher employment, solid industrial production growth and upside surprise in PPI

Enterprise sector net hiring amounted in April to 14k, bringing annual growth rate of employment to 0.0% (a way above quite optimistic consensus of 0.2% y/y and our forecast). The labor market is swiftly making up the gap after the slowdown (mind the difference between the 2001-2002 slowdown, red arrows in the attached figure). The released data corroborates our view that the demand for labor is gaining momentum and in the following months we may expect positive monthly growth of employment on average. This process alone, accompanied by the overall rise of consumer optimism and good momentum in manufacturing sector, are likely to carry GDP growth over in the next quarters and 2011 (all this conditioned that there will be no major spill-over of debt crisis to banking sector. The worst case scenario is still not confirmed by money market spreads though.). In other words, recent data do not support the notion that GDP will soon enter the plateau phase, what reflects market consensus for now.

Monthly employment growth in April, 1997-2010



Industrial output rose by 9.9% y/y in April in line with the underlying trend. Slight drop in annual dynamics vs. 12.3% y/y seen in March is due to working days effects. In SA terms output rose by 8.8% only 1 pctg point below March figure. The breakdown continuously indicates strong exports component and co-movement with the rising industrial orders in German economy. While fore-casting the industrial output for the next 1-2 months one should certainly account for some ad-verse effects related to the flood in Southern Poland. However, we do not expect the underlying trend to change soon.

As for producer prices, their growth amounted to 1.2% m/m (-0.5% y/y after -2.4% in the previous month) much above the value implied from our econometric model and consensus forecast. Part of the growth naturally stems form PLN depreciation, although the magnitude of the transmission seems quite high. It is probably not a coincidence that large depreciation matched a substantial rise of producer price expectations (the mechanism might have been simple this time: NBP inter-vention at the 3.82 EURPLN bottom fuelled expectations of higher exchange rate in the future, built-in immediately in price-lists). In the next months we may expect the growth of producer prices to calm down a bit, but the momentum might have been permanently inverted from down-ward to upward (see also a piece below on the managed float in Poland). So far the growth of producer prices is neutral for CPI inflation and any transmission of higher prices will be for some time disguised by base effects in the CPI. However, the transmission is very likely to become visible in H2, along with accelerating economy.

Towards the managed float in Poland

Yesterday we saw Polish FinMin selling the euro via a state owned BGK Bank (it is the second such move over the lat 12 months). It was the 4.20 EURPLN level which triggered the intervention. FinMin in its communiqué on the web page reiterated that it may use the zloty mispricing (deviation from fundamentals) to sell the euro also in the future, which we see as a clear commitment to further interventions. This strategy, corresponds to the ideas of introducing managed float in Poland presented by some MPC members (Bratkowski in particular). Taking into account the April NBP intervention at the EURPLN level of 3.82 which was aimed to revert the zloty appreciation, it is easy to calculate that the preferred level of the EURPLN should be close to 4.00.

The underlying cause for the FinMin intervention was the break of mid-term EURPLN-EURUSD correlation and abrupt zloty weakening. One should note, however, that the most recent market reaction was probably linked to the exchange rate policy pursued by the NBP. April NBP intervention might have created the impression that there is a limit for further zloty appreciation. Thus the risks for the zloty seemed to be asymmetric and the dominating trade was to bet on a rapid, limit-less zloty depreciation. This happened to be triggered by a shaky situation on the global market and significant outflow of foreign capital from the Warsaw Stock Exchange (WSE was among those worse hit by the recent correction).

Through such a behavior, FinMin and NBP expose themselves on a serious risk. In case when the alleged defended levels (4.20) are broken by portfolio investors, we may expect the pace of depreciation to gain in speed (investors seeking another defended levels). However, such a scenario's probability is low if only global financial markets stay stable (in these circumstances managed flow seems a sensible policy as it prevents small scale but persistent EURPLN speculation). The mentioned probability would rise substantially if capital outflow and home bias (phenomena recently gaining importance in the global markets) gain strength. In such a state of the world any defense positions are deemed to fail.

Currency interventions and abandoning the free float regime carry also some strict economic risks: higher inflation and lack of amortization of idiosyncratic shocks. Such a strategy may only support building of imbalances in the Polish economy.

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

Quiet warning.

Last week FI market was rather calm. Despite touching high in the 2y10y at 115bp activity was rather limited. Reaction after higher than expected CPI release (2.4 versus 2.3 expected) was rather tame. Curve moved up by no more than 3-5bp, and to the surprise the worse performer was the long end of the curve. Move was quickly faded and price action remained in very tight range. As for the road bonds auction, they sold at reasonably neutral price. But as the week was ending, the sentiment started to deteriorate. There is hardly any new news in the market, but the MPC behavior (exchange-rate-centric approach, plus quarrels among the rate-setters body) looming presidential elections, the flood in southern part of Poland; all is making situation look difficult from investment perspective. The other problem is that we didn't have any proper sell off in bonds, or in ASW to be more precise, which would clear the tension from the market. Our view is that positioning is rather heavy and it is has been build at rather unfavorable level. EURPLN is trying to find its new range, and everyday it stays well above 4.00, which may be helping economy (we argue it needs extra stimulus over here) but it is definitely influencing CPI in a nasty way (the PPI reading for the last month shows that there are some inflationary mechanisms in the economy after all …). Other harmful factor is volatility. While one observed on the FX market, WSE is in a rising trend, one should be very careful, cause we may see a sudden move in bonds/rates. Economy is moving away from equilibrium which we used to enjoy over the last 2-3 years … it is now just a quiet warning. Generally, we are looking forward to see some risk premium in the curve … a lot more risk premium.

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	5/31/2010	-	3.794%	5/17/2010
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

Carry still high

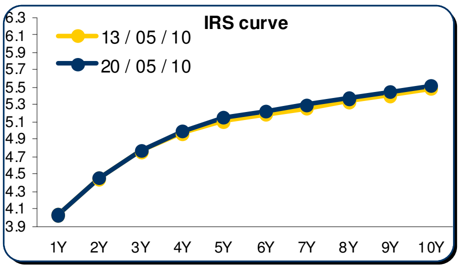
Cost of carry relatively high comparing to the funds available in the system. Probability of cheap end of the reserve still high. Too soon to announce the change in the trend, however this issue should be observed very carefully. Tomorrow's open market operation will be definitely indicative what happens at least short term. On the other side the higher uncertainty on the financial markets the cheaper cash should be, reflecting increased risk aversion. Therefore the current situation may be nothing more than temporary disorder.

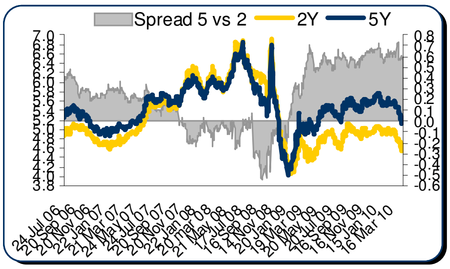
Club Med issue shows the path

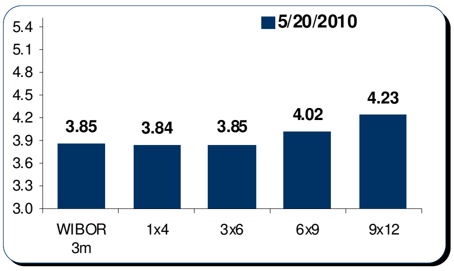
Longer rates slightly up, however risk is still growing due to the Club Med countries, and threat that EU plus IMF aim is just postponing a real crash. Currency is weakening and the correlation of the interest rates with the exchange rates is broken now. Mean reversion mechanism is very likely though.

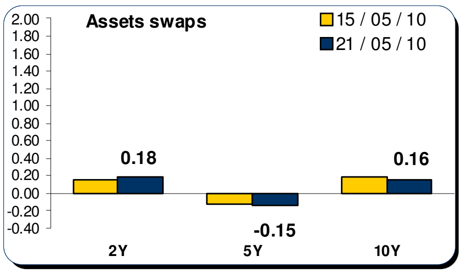
Real economy data quite good this month and so far. CPI slightly above expectation, wages slightly below. Signals from the labor market are still improving.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Not Zloty weaker, but Zloty weaker again to be more precise. Fundamental roots and complexity of Eurozone problems are likely to affect risk aversion level for more than short-term trading.

Zloty weaker

This week has started with EURPLN trading around 4.04, to briefly dive below 4.000 only to shoot up to 4.2050 resistance. Where for time being the local resistance has been meet not without the help of ministry of finance selling EURPLN via BGKW on the market. The swings of USD/PLN were even more extensive.

Implied volatility higher

Secondary trading of same levels has run on lower realized volatility. In other words 4.5% higher EURPLN rate translated into 18.6% volatility. Number still high but not as shocking as previous 40ish levels. Anyway weaker Zloty in a 'hostile environment' took implied curve higher, benchmarks 3M and 1Y were traded at 14.5 and 13.75, whilst last week close levels were 13.0 and 12.25. Smile reaction was bit harder: 3M 25D RR was traded at 4.5 - 1 vol higher than previous week's close. USDPLN vs EURPLN currency spread driven by new spikes in EURUSD vols has fixed at 7.5%

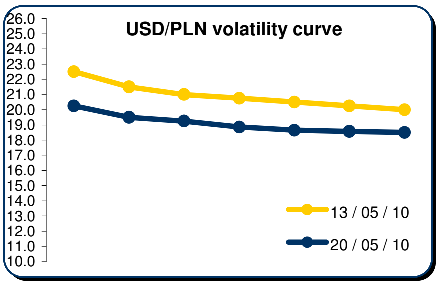
Short-term forecasts:

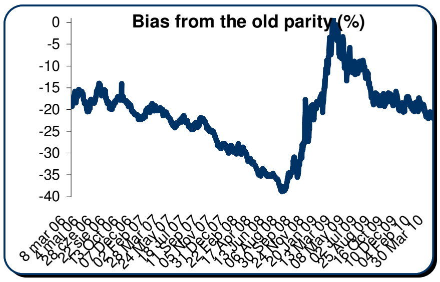
SPOT
Main supports / resistances:
EUR/PLN: 4.0650 / 4.2400
USD/PLN: 3.2120 / 3.5750

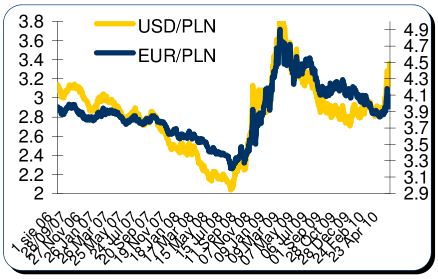
We have not seen such expected consolidation but big come back to risk aversion trading. Because these levels were traded before local real flows are limited, but series of EURPLN negative recommendations has created some turnover and market positioning is short Zloty. Key is 4.24, broken or not should set Zloty sentiment for coming week.

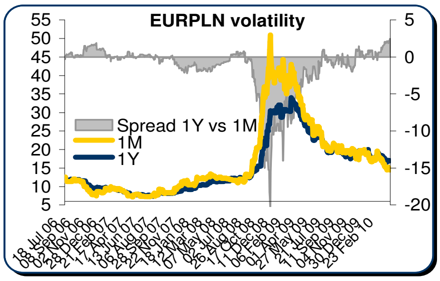
OPTIONS
We have traded long Gamma here, it's the best possible trade for the current conditions of incredible spot realized volatility. So we still maintain it as our plan for nearest future. It's simply hard to stop…On other hand we play vega range at the moment, that range translates for 1 Y EUR/PLN ATM as 11.5% - 15.5%. We can not exclude the break out of this range to the upside, but in our opinion it should be temporary.

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
14/05/10	3.70%	3.86%	3.93%	3.92%	4.13%	4.17%
17/05/10	3.77%	3.85%	3.89%	3.91%	4.16%	6.59%
18/05/10	3.75%	3.85%	3.90%	6.49%	4.15%	4.16%
19/05/10	3.70%	3.85%	3.90%	3.90%	4.15%	4.16%
20/05/10	3.80%	3.85%	3.90%	3.91%	4.15%	4.16%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
14/05/10	3.85%	3.86%	3.96%	4.21%	4.19%
17/05/10	3.86%	3.86%	3.99%	4.16%	4.18%
18/05/10	3.86%	3.86%	4.01%	4.17%	4.19%
19/05/10	3.85%	3.86%	3.98%	4.19%	4.19%
20/05/10	3.85%	3.85%	3.98%	4.21%	4.20%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IRS	DS1017
14/05/10	4.17%	3.78%	4.43%	4.19%	5.12%	4.99%	5.48%	5.66%
17/05/10	6.59%	3.74%	4.42%	4.23%	5.10%	4.99%	5.50%	5.68%
18/05/10	4.16%	3.79%	4.41%	4.20%	5.07%	4.95%	5.44%	5.63%
19/05/10	4.16%	3.74%	4.46%	4.21%	5.15%	5.00%	5.52%	5.68%
20/05/10	4.16%	3.74%	4.46%	4.21%	5.15%	5.00%	5.52%	5.68%

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
14/05/10	21.25	20.50	20.00	19.75	4.40	5.15	0.70	0.90
17/05/10	22.50	21.50	21.25	20.75	4.65	5.65	0.75	0.95
18/05/10	23.00	22.00	21.75	21.50	5.15	5.75	0.75	0.95
19/05/10	23.00	22.00	21.75	21.50	5.15	5.75	0.75	0.95
20/05/10	23.00	22.00	21.75	21.50	5.15	5.75	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
14/05/10	3.1860	3.9852	-20.31%
17/05/10	3.2770	4.0244	-19.26%
18/05/10	3.2284	4.0038	-16.95%
19/05/10	3.3595	4.0898	-15.39%
20/05/10	3.3595	4.0898	-15.39%

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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