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FINANCIAL MARKETS DEPARTMENT
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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

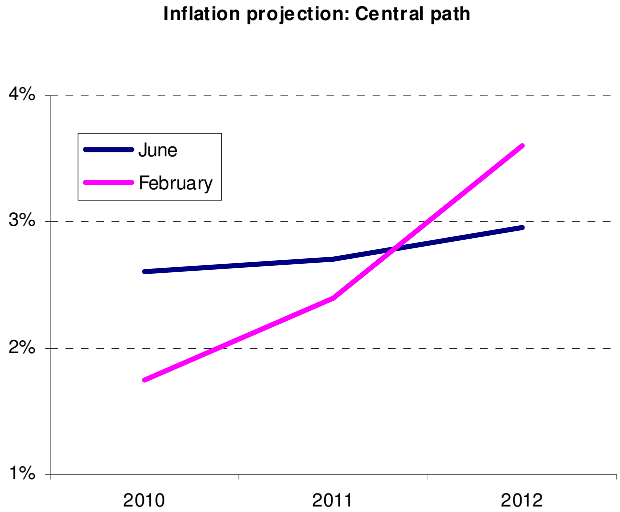
PREVIEW: The week of July 2nd 2010 to July 8th 2010

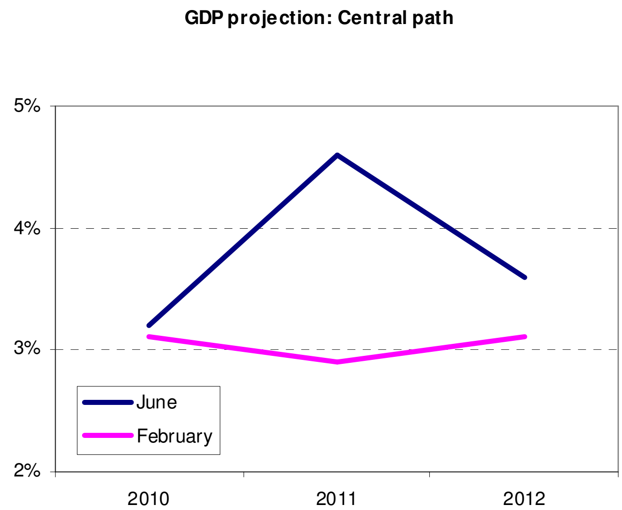
Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
NO SIGNIFICANT RELEASES						

In Focus / Macroeconomics

Rates on hold. Bias changed between the lines.

The event was unexciting as far as rates are concerned, but a combination of reading between the lines and the message delivered by the governor after the meeting suggests there was some sort of a bias change towards more restrictive. The meeting was accompanied by the publication of new inflation projection (see the figures below) showing more buoyant growth path but flatter inflation.





The statement mentions a bunch of risks concerning external environment: fallout of the debt crisis, fiscal consolidation, some moderation of growth rate of various indicators abroad accompanied by slipping business tendency indicators. However, even though those factors are cited, the real sphere of the Polish economy is assessed in a more upbeat tone; the only headwind is given by investment activity and low credit growth for enterprises – both regarded as typical in the ongoing phase of the business cycle (the assessment on this field seems more optimistic than the one delivered in recent “Minutes”).

As for inflation, current environment is described as rather benign. However, the same does not apply to the perspectives, as the lists of pro- and dis-inflationary issues has been replaced by a simple passage stating that there was discussion only on pro-inflationary factors (combining this with the additional remarks given at the meeting we it is not a coincidence). Furthermore, the governor supplemented the statement by the phrase „the probability of inflation staying above the target in 2012 is higher then the other way round" which we regard as a verbal substitute for the change of bias written formally in the statement.

The policy-mix section of the statement reveals the determination of the MPC to push for more vigilant reduction in budget deficit. The tone of the meeting suggests the new MPC governor (not a surprise given his IMF experience) would like to see more tighter fiscal policy, especially when no progress on this field means a relative recourse given the consolidation planned in the euro zone and the CEE region. Probable that was the reason why the statement in which MPC used to stress "fiscal measures" as an important determinant of monetary policy now calls for "decisive measures". The lack of those measures in the months ahead may be additional stimuli for more decisive monetary policy, either in terms of a mere tempering loose fiscal policy or, in extreme but not excludable scenario, in terms of compensating the risk reward for investors in case of a bond sell-off connected with unreliable fiscal consolidation plan (some sort of Hungarian scenario).

The issues connected with the zloty stability and its influence on inflation evaporated from the statement. However, the zloty exchange rate seem to pop up at the conference as a most important inflationary factor at the moment. That is why we think that combination of weaker zloty (compared to the earlier episodes with monotonic appreciation) and fiscal policy will be crucial for monetary policy. Higher inflation (probably to a notable extent induced by the weaker zloty) and somehow the will to signal the risks of fiscal policy are going to induce monetary tightening before the end of the year. The risk of such scenario should be (at least to some extent) reflected in FRA rates. However, the prolonged period between decisive MPC meetings (that on July 6. is only a technical, non-decision one), along with mixed bag of data and still falling inflation (lowest rate in July) may somehow temper rate hike expectations. The same applies to the presence of new MPC governor Belka who seems to be have implemented changes in market communication scheme (shorter statement, change of bias hidden between the lines and conjectured from Q&A session).

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	**3.1↑**	4.2
Inflation rate (%, average)	2.4	4.3	3.5	2.6	2.9
Current account (% of GDP, average)	-4.5	-5.3	-1.6	**-1.8↑**	**-2.9↑**
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	3.75	5.00

Indicator		2009			2010	
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	1.7	3.1	3.0	**2.7↑**	**3.2↑**	3.9
Inflation rate (%, average)	3.5	3.3	3.0	2.1	2.2	2.8
NBP repo rate (end-of-quarter)	3.50	3.50	3.50	3.5	3.5	3.75

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

Fixed Income

Breaking point.

Last week turned out to be quite lazy but interesting. The market seemed to become very resistant to the external pressure but surprisingly we could see quite opposite interests traded on the yield curve. Before the MPC meeting outcome we could observe quite substantial receiving move in 2y5y spread trading down at 55 points. As a result the 5Y swap dipped down to 5.14% flattening further the curve without any significant change up to 2Y.

To the contrary, the MPC meeting press conference on Wednesday led by the governor Belka, brought quite a hawkish sentiment to the short end of a curve. Though the unchanged rate verdict wasn't a surprise to the market, Belka stressed there were new risks that might fuel inflation in the future. The clear rebound in industrial output and recent PLN weakness could have a direct or "indirect" influence on a price growth, he pointed out. As a result he presented the upward revision to the inflation forecasts that might clearly generate and support the increasing hawkish view. What was the most interesting, the MPC decided not to present the balance of risks anymore as the new CPI projection would be easily understood as a swap to the restrictive attitude.

The short end of a yield curve reacted quite "positive" to the MPC meeting outcome and went up around 5-9bp with the most aggressive buying interest from 3x6 to 6x9 FRA contracts (3x6 FRA from 3.90% to 3.99%, and 6x9s FRA from 4.14% to 4.20% respectively).

Concluding… We think we face a change in an official MPC attitude to the price risks that might anchor the short end FRA contracts on the quite high levels and pricing the potential interest rate hikes in the second half of a year. On the other hand we are not quite sure why the markets try to enter the long-end receiving positions as we don't think that both internal and external risks have already vanished.

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	7/5/2010	-	4.072%	6/28/2010
2Y T-bond OK0712	7/7/2010	-	4.675%	6/2/2010
5Y T-bond PS0415	7/14/2010	-	5.156%	5/12/2010
10Y T-bond DS1020	7/21/2010	-	5.790%	6/16/2010
20Y T-bond WS0429	7/21/2010	-	6.170%	9/23/2009

Money Market

Hard to explain turmoil on the PLN cash market

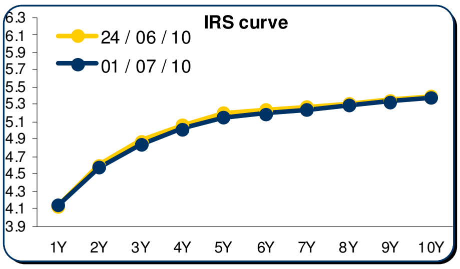
Huge turmoil on cash market bears the question in what direction are we going? Despite the purchase of 75.5 billion pln of the money bills, there was still huge surplus in the system during the last day of the reserve. Nonetheless, the great majority of the market was short and the ON rate was extremely high taking into consideration the mentioned surplus. Moreover, we started the new reserve really expensive (above the main rate) and again the market as a whole is not even short!! Predicting liquidity in this unusual environment becomes impossible, since we do not know the cause of this squeeze. Tomorrow's OMO can bring the answer unless the problem is structural. If it is, the causation can be long lasting (e.g. further decrease of the credit lines and more asymmetric layout of the liquidity in the system, which disables the redistribution of the surplus). All this pushed the ois curve significantly up.

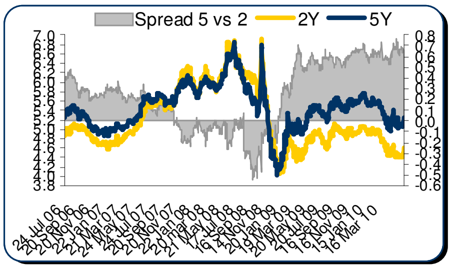
Change of unofficial bias by the MPC

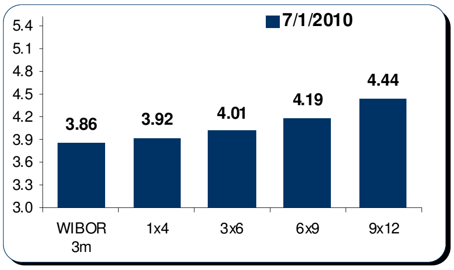
The MPC did not change any of the monetary policy parameters. The statement, however, made by the new head, was quite interesting and most probably changing the unofficial bias from neutral to restrictive.

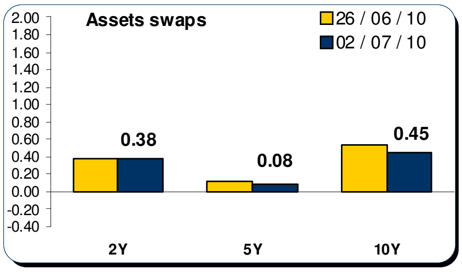
T-bills average yield again up on weekly tender to 4.07% from 3.98%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty boxed in range

On Monday Zloty initially had extended last week loses to the top of the current range (4.00/4.20), with touching EURPLN 4.1770 high on early Tuesday. Following days were dominated by side trading bounded by 4.1200/4.1770 range. Zloty is still a hostage to the global sentiment (correlation with EURUSD, EURJPY and DJ about -0.6/-0.7) while the impact of ongoing presidential elections is limited .

Implied volatility higher

Several touches of range bounds has elevated realized volatility to 12% (Mon-Thu) and 14% (Thu-Thu). So although we reckon implied curve is spot level driven in reverse to previous weeks (when it was supported by historical volatility), short end is also supported. This week benchmark (3M EURPLN ATM) was traded between 13.5 (Mon spot 4.14) and 14.0 (Thu spot 4.17). Smile (3M 25D EURPLN RR benchmark) is levelled in a 3.75/4.25 tight range. EURPLN vs USDPLN currency spread is traded, despite higher spot, at similar 8.5 level.

Short-term forecasts:

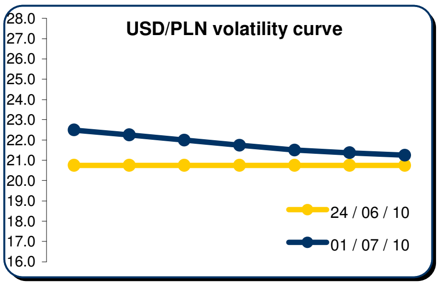
SPOT
Main supports / resistances:
EUR/PLN: 4.0400 / 4.2000
USD/PLN: 3.3500 / 3.5000

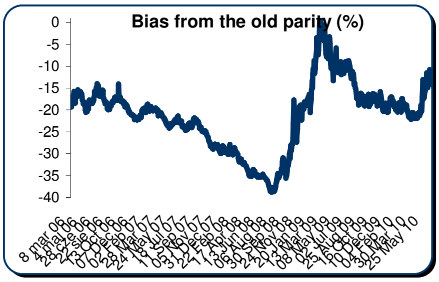
EURPLN is close to top of present range which gives a good chance to see a reversal.

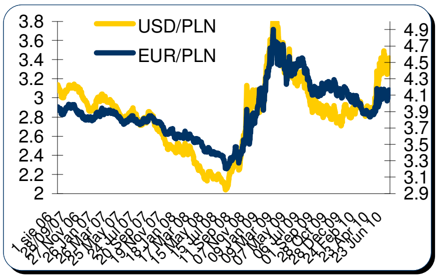
OPTIONS

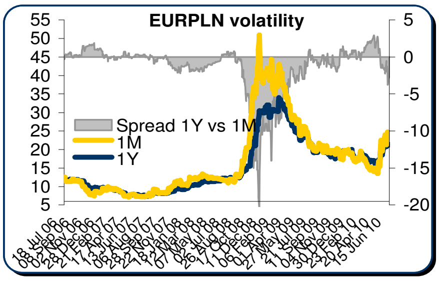
Influence of periods of low realized volatility is netted out by days of boosted one. It is still happening. Sentiment fluctuations provides enough bargains to look for higher gamma. However, it has to be taken into account that the historical volatility is now heading lower. From the Vega point of view it is possible to see some downward potential, although as soon as situation calm down, the tendency may be somehow (temporarily?) disturbed.

FX CHARTS


USD/PLN volatility curve
24 / 06 / 10
01 / 07 / 10


Bias from the old parity (%)


USD/PLN
EUR/PLN


EURPLN volatility
Spread 1Y vs 1M
1M
1Y

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
25/06/10	3.72%	3.85%	3.89%	3.89%	4.10%	4.14%
28/06/10	3.72%	3.85%	3.87%	3.89%	4.10%	6.59%
29/06/10	3.77%	3.85%	3.87%	6.49%	4.13%	4.14%
30/06/10	3.75%	3.86%	3.90%	3.89%	4.32%	4.15%
01/07/10	3.78%	3.86%	3.91%	3.90%	4.16%	4.15%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
25/06/10	3.86%	3.90%	4.14%	4.39%	4.36%
28/06/10	3.87%	3.91%	4.15%	4.38%	4.37%
29/06/10	3.87%	3.90%	4.14%	4.37%	4.35%
30/06/10	3.87%	3.90%	4.14%	4.37%	4.36%
01/07/10	3.88%	3.92%	4.17%	4.41%	4.37%

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
25/06/10	4.14%	4.06%	4.59%	4.52%	5.20%	5.32%	5.40%	5.93%
28/06/10	6.59%	4.10%	4.61%	4.52%	5.21%	5.32%	5.42%	5.93%
29/06/10	4.14%	4.11%	4.61%	4.52%	5.18%	5.28%	5.40%	5.91%
30/06/10	4.15%	4.13%	4.58%	4.52%	5.15%	5.23%	5.38%	5.83%
01/07/10	4.15%	4.13%	4.58%	4.52%	5.15%	5.23%	5.38%	5.83%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/06/28	11/06/28	96.045	4.07%	1800	2788	1442
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	10/06/16	19/04/25	95.807	5.79%	3000	2965	2430

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
25/06/10	22.25	22.00	21.75	21.50	4.75	5.90	0.75	0.95
28/06/10	22.25	22.00	21.75	21.50	4.75	6.10	0.75	0.95
29/06/10	23.00	22.25	22.00	22.00	5.00	6.10	0.75	0.95
30/06/10	22.85	22.50	22.25	22.00	5.00	6.00	0.75	0.95
01/07/10	22.85	22.50	22.25	22.00	5.00	6.00	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
25/06/10	3.3643	4.1405	-13.50%
28/06/10	3.3270	4.1148	-13.58%
29/06/10	3.4157	4.1649	-14.09%
30/06/10	3.3946	4.1458	-13.87%
01/07/10	3.3773	4.1529	-14.22%

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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