



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

IN FOCUS / MACROECONOMICS	<ul style="list-style-type: none"> • <i>June inflation surprises on the upside</i> 	<ul style="list-style-type: none"> • <i>page 2</i>
FIXED INCOME	<ul style="list-style-type: none"> • <i>CPI and auction, both negative surprise</i> 	<ul style="list-style-type: none"> • <i>page 3</i>
MONEY MARKET	<ul style="list-style-type: none"> • <i>Record OMO</i> • <i>3M repo just a formality</i> 	<ul style="list-style-type: none"> • <i>pages 3-4</i>
FOREIGN EXCHANGE	<ul style="list-style-type: none"> • <i>Zloty glued to 4,0600</i> • <i>Implied volatility aggressively lower</i> 	<ul style="list-style-type: none"> • <i>page 5</i>
MARKET PRICES CONTACT LIST DISCLAIMER		<ul style="list-style-type: none"> • <i>page 6</i> • <i>page 7</i> • <i>page 8</i>

PREVIEW: The week of July 16th 2010 to July 22nd 2010

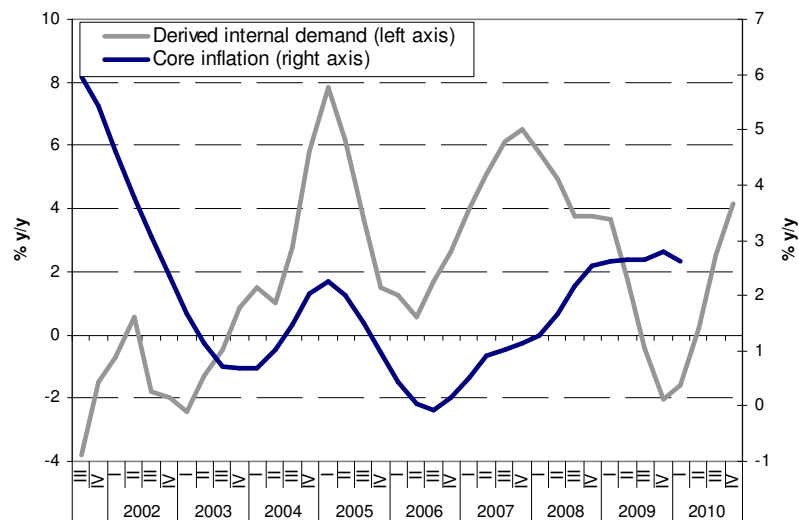
Indicator	Date of release	Pe-riod	BRE forecast	Consensus	Last	Comment
Wages	Jul 16	Jun	2.7%	4.6%	4.8%	Higher growth in manufacturing maintained. Some one-offs in last month's mining wages erased.
Employment	Jul 16	Jun	1.0%	1.0%	0.5%	Monthly growth of employment at 12-16k. Manufacturing posting gains in the second month in a row. Possibly high growth in construction and the unlabelled "rest" (positive flood effects, identified at the unemployment rate level).
Industrial output	Jul 19	Jun	11.0%	11.2%	14.0%	No difference in working days. Negative momentum in the new orders aggregate. Ambiguous role of extraordinary effects. Our forecast constitutes probably the floor for the possible readings as auto production proved to very robust in June.
Producer prices	Jul 19	Jun	1.5%	1.6%	1.6%	Another substantial growth on monthly basis as an aftermath for recent rises, base effect from the last year masks the momentum.
Core inflation	Jul 20	Jun	1.5%	1.5%	1.6%	Moderate growth in core categories. Downward potential in recent months on base effects.
Retail sales	Jul 23	Jun	2.7%	4.0%	4.3%	Business tendency indicators pointing downwards, together with consumer pessimism. We expect heterogeneous result, with home appliances and durable goods at the top (wealth restoration) and food sales at the bottom.

In Focus / Macroeconomics

June inflation surprises on the upside

June inflation rose to 2.3% from 2.2% y/y recorded in May. Analyst expected price pressure to subside towards 2.1% y/y. The discrepancy between the analysts' forecasts and the actual figure is attributable to higher food prices which rose by 0.5% m/m, i.e. by more than was implied by their seasonal pattern. Fuel prices were up by moderate 0.4% and energy prices rose by 0.5% which was the result of state-controlled natural gas price hike. In the vast majority of categories prices moderated leading core inflation lower. We estimate the June core inflation rate at 1.5% y/y vs. 1.7% recorded in May.

Although one may expect a slightly lower (probably close to 2.0% y/y) inflation in July on the back of statistical base effect resulted from zloty depreciation in H1 2009, unfavorable weather conditions (leading to higher food prices) and inversion of statistical base effects are expected to push inflation higher in Autumn. At first, the turnaround of inflation is set to be seen in the headline CPI while the core is going to stay under the influence of statistical base effects. In the next months the rebound is likely to be reinforced by the core inflation, shaped by rising domestic demand, higher labor costs and – last but not least – weak and volatile zloty exchange rate (see to graph along with the short explanation below). The end of year headline inflation rate is thus very likely to hit 3.0%.



In the graph above we present an interesting behavior of two series. Derived internal demand is estimated econometrically from the industrial output series stripping the growth attributable to exports and formation of stocks (it has advantage over internal demand from national accounts as it excludes much of infrastructure investment, led by non-market decisions and somehow disturbing the shape of the private business cycle). Derived internal demand is presented as a lagged (t-3) 3-month average, the same smoothing method applies to core inflation (current series, t). Derived internal demand has some quite strong predictive features and point that – more or less – the fall of core inflation is more or less done and we are going to climb upwards as soon as base effects fade out.

We are aware that the mood in the MPC swift towards more dovish (many MPC members would rather disapprove an inflation-dictated rate hike shifting at the same time the focus rather on financial system stability and other macroeconomic issues). We stick, however, to our view that rising inflation and probably less favorable situation in the financial markets (a result of disappointing fiscal polity) may force the MPC to tighten the monetary policy this year.

**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 changes from the last release with arrows showing the direction of changes

Fixed Income

CPI and auction, both negative surprise.

There was two main events that has weighted on the market in the past week. First one was the CPI reading which came at 2.3% versus 2.1 expected by the market. Second one was very poor auction of 5y bonds which drew only PLN 2.8 bio demand (lowest in 9 months). Price action pushed yields in 2y to 4.60% and in 5y to 5.17%. Activity in the market is rather slow, and it is pretty hard to guess where market liquidity is for real. Market got used to rather tight range both in bonds and rates, but if we will be trying to break this range first reaction can be quite surprising in the magnitude. Our call is still for higher rates on the curve and all arguments from the last week are still valid. CPI is on the rising path, fiscal situation can materialize to be much worse than market is hoping after Komorowski's win, and positioning in Polish bonds is still heavy. Things to look on Friday will be wages (showing strength of the labor market) and next week's PPI (high influence of EURPLN) and IP.

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	7/19/2010	-	4.025%	7/12/2010
2Y T-bond OK0712	8/4/2010	-	4.740%	7/7/2010
5Y T-bond PS0415	8/11/2010	-	5.373%	7/14/2010
10Y T-bond DS1020	9/15/2010	-	5.790%	6/16/2010
20Y T-bond WS0429	9/15/2010	-	6.170%	9/23/2009

Money Market

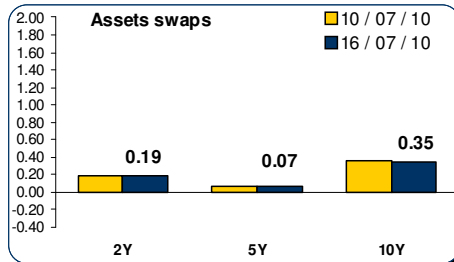
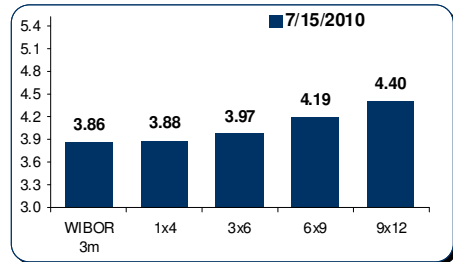
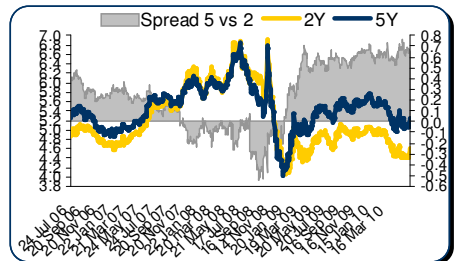
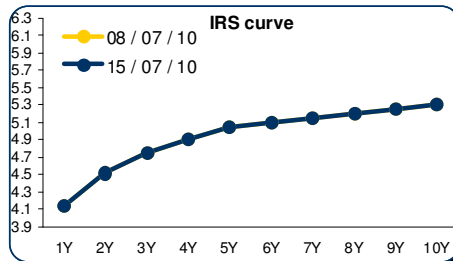
Record OMO

New record during the OMO auction. The market bought PLN 79 billion of the money bills, and was left with a shortage of nearly PLN 4 billion!!! Therefore, the shortest rates went up and ON deposits were traded even above the yield of the bills. It would be logical if the demand during tomorrow's OMO would be much lower, just to meet the reserve requirements by the system.

3M repo just a formality

3M repo with the central bank was just a formality. NBP offered PLN 100 mio and the demand was below PLN 40 mio. It means that the repo can be pooled back from the regular schedule next quarter.

FIXED INCOME & MONEY MARKET CHARTS



Foreign Exchange

Zloty glued to 4,0600

During last week Zloty was boxed in extremely tight range 4,05/4,09. Polish currency was surprisingly immune to global risk developments, namely, higher EURUSD, EURJPY, good performance of global exchanges. All the above was not enough to break 4,05/4,06 support level. The rumour on the streets says it is PKO BP buying hard currency for the purchase of BZ WBK. But it is unconfirmed, and for us it is unlikely, as the PKO BP has not even won the race for purchase of the shares of BZ WBK, in the first place.

Implied volatility aggressively lower

The realized volatility is falling like a stone, the impact for implied volatility especially in the short end was devastating. 1 week EURPLN have dropped from 12.5 % mid to 9.75 %, 1 month from 12,5% to 10,75%, 1 year from 13,25% moved down to 12,60%. Risk reversals were discounted around 0,25%. The next sign of risk appetite is diminishing currency spread (the difference between USD/PLN and EUR/PLN vols) it is today 7 %, last week it was 8,25 %.

Short-term forecasts:

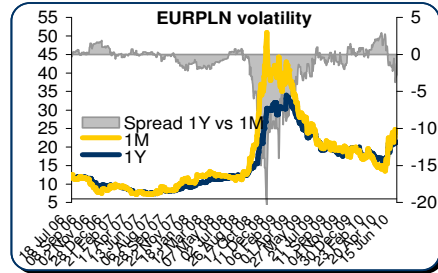
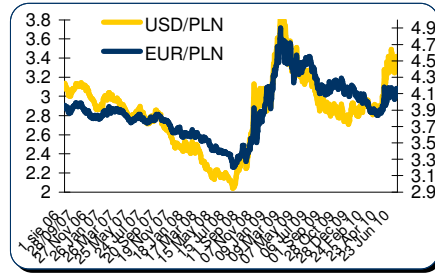
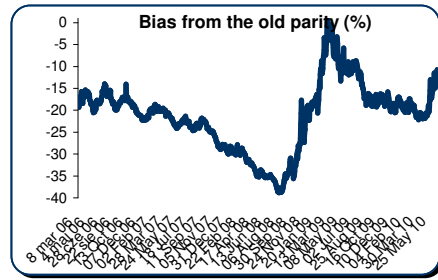
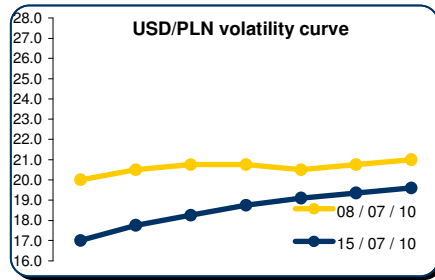
SPOT
Main supports / resistances:
EUR/PLN: 4.0000 / 4.2000
USD/PLN: 3.1000 / 3.2500

We do not really understand why the Zloty is not rising on the back of the global recovery. Wider 4,00/4,20 range is still intact.

OPTIONS

In our opinion we are approaching bottom levels of implied volatility (mid curve). Being aware of the low historical volatility performance, one may try to exploit it by Vega and Vanna position using Gamma neutral spreads.

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
09/07/10	3.75%	3.84%	3.89%	3.90%	4.14%	4.15%
10/07/10	3.80%	3.84%	3.90%	3.90%	4.15%	6.59%
13/07/10	3.80%	3.85%	3.92%	6.49%	4.16%	4.14%
14/07/10	3.74%	3.86%	3.92%	3.90%	4.18%	4.14%
15/07/10	3.72%	3.86%	3.91%	3.90%	4.14%	4.14%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
09/07/10	3.87%	3.97%	4.17%	4.38%	4.36%
10/07/10	3.88%	3.96%	4.17%	4.38%	4.35%
13/07/10	3.89%	3.96%	4.14%	4.36%	4.34%
14/07/10	3.86%	3.95%	4.15%	4.36%	4.31%
15/07/10	3.90%	3.96%	4.16%	4.36%	4.34%

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
09/07/10	4.15%	4.05%	4.55%	4.32%	5.09%	5.15%	5.34%	5.70%
10/07/10	6.59%	4.05%	4.55%	4.32%	5.09%	5.15%	5.34%	5.70%
13/07/10	4.14%	3.99%	4.58%	4.36%	5.12%	5.22%	5.34%	5.71%
14/07/10	4.14%	4.06%	4.60%	4.36%	5.15%	5.22%	5.36%	5.71%
15/07/10	4.14%	4.06%	4.60%	4.36%	5.15%	5.22%	5.36%	5.71%

PRIMARY MARKET RATES

Last Primary Market Rates							
	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/07/12	11/07/12	96.089	4.03%	1000	4116	1000
OK0712	10/04/07	12/07/25	89.301	4.54%	3000	6726	2999
PS0415	09/07/14	15/04/25	100.483	5.37%	3000	2807	2027
DS1019	10/06/16	19/04/25	95.807	5.79%	3000	2965	2430

FX VOLATILITY

date	USD/PLN 0-delta straddle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
09/07/10	20.50	20.75	20.50	21.00	4.00	5.00	0.75	0.95
10/07/10	20.50	20.75	20.50	21.00	4.00	5.00	0.75	0.95
13/07/10	19.50	20.00	19.75	20.25	4.00	5.00	0.75	0.95
14/07/10	18.50	19.25	19.50	20.00	4.00	5.00	0.75	0.95
15/07/10	17.75	18.75	19.10	19.60	4.00	5.00	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
09/07/10	3.2124	4.0733	-13.27%
10/07/10	3.2124	4.0733	-13.27%
13/07/10	3.2499	4.0775	-12.13%
14/07/10	3.1925	4.0605	-12.24%
15/07/10	3.1750	4.0600	-13.05%

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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