FINANCIAL MARKETS DEPARTMENT

PAGES: 8 WARSAW, AUGUST 20, 2010

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of August 20th 2010 to August 25th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Core inflation	Aug 20	Jul	**1.2%**	1.2%	1.5%	Falling on base effects.
Retail sales	Aug 24	Jul	**6.2%**	4.5%	6.4%	One working day less. Quite disappointing auto sales. Reading dominated probably by food and fuel sales. Downward risk.
MPC decision	Aug 24	-	**3.50%**	3.50%	3.50%	Meeting after more the 50-day pause. MPC still in a wait-and-see mood with bias rather towards longer period of easy monetary policy. We think this may change no sooner than within 3-4 months time along with the inflow of new data.

In Focus / Macroeconomics

Macroeconomic data showing no weakness

The market apparently went wild on two pieces of data: lower inflation in June and meager growth of corporate wages. In our opinion, such a reaction was not justified by the data and was rather triggered by some external factors (low yields environment in the euro area) and stop-loss hunting. The data per se do not convey a bullish (price wise) message. First of all, CPI was dragged down by the food prices (disconnected from the state of the real sphere of the economy) and core inflation is falling on base effects, reflecting still only a past momentum. Secondly, we do not know much about the reasons why the growth rate of wages plunged, whether it was a holiday effect (lower number of extra hours worked), or some bonus issues in mining. Thirdly, the data on wages and inflation are backward, not forward looking. We have the other, more leading data suggesting the other scenario is more possible: rising employment, decent industrial output and climbing producer prices. However, we agree that the market (and the MPC) has to see better current, nominal data, to believe the things are going the other way round. It may take 2-3 months for this to really happen.

The shockers of ambiguous importance

Although we doubt that one-offs driven wage and inflation do really contain important forward-looking elements, in common opinion they confirmed the MPC may stay idle and inflationary pressures are gone for long.

Inflation fell from 2.3% to 2.0% in July, beating the Ministry of Finance conservative forecast (2.1%). However, the sole contributor to the decline were food prices which – strangely breaking the pattern form the last month – were magnified towards usual seasonal variation, allowing for a 1.1% monthly decline. Core inflation dropped to 1.2% from 1.5% largely on base effects (which will keep this measure in check also in the coming months).

The market sentiment was supported by falling wages. July saw corporate wages dynamics decreasing from 3.5% to 2.1% y/y (consensus 3.9%). Note that the data on corporate wages are preliminary (no breakdown is presented) and give no clue about the nature of the lower growth. It is likely, however, that July wages have been affected by two factors: 1) lower working days number on an annual basis, 2) extremely hot weather could make employees cut on extra hours worked. Taking into account the employment trends we still see wages growing by about 5% in 2010.

In the paragraphs below we argue that the behavior of wages and inflation says nothing about their future trends and it is more reasonable to look at real-value figures carrying more leading properties.

Real-value figures

July saw industrial production rising by 10.3% y/y vs. 14.3% recorded in June and consensus forecast of 12.3%. Lower than expected outcome can be attached to negative working-day effect and extreme (hot) weather, with the latter working through probable understaffing and lower number of extra hours worked. The same effect can be seen in construction output which recorded a meager growth rate of 0.8%, down from 9.6% y/y reported in June. It is likely that apart from holiday workers' "migration", construction was also capped for technological reasons (as the core driver used to be road infrastructure, extreme temperatures usually limit production possibilities). In SA terms industrial output slowed to 11.3% y/y from 11.7%, so there is less room than commonly thought to complain about. In our opinion, one cannot formulate hypotheses on slowdown in manufacturing basing on this very specific month. Apart from exports, the domestic component of industrial output is expanding as well, invoking potential to make Polish industry growth self-reinforcing.

Producer prices accelerated sharply to 3.9% y/y in July. Although much of the rise stems from last year's base effects, the positive momentum in manufacturing prices has been maintained (+0.3% m/m and +0.2% in ex-energy terms). It seems that recent NBP's fiddling with EURPLN rate bears long-lasting effects, reflected mainly in elevated price-expectations. Although the competition among producers is still harsh enough to prevent them to pass costs on consumers, it seems that it is only a matter of time until it happens (we see the survey-based capacity utilization measures presented by the GUS as a poor measure of prospective price pressures; it is far more reasonable to think in terms of industrial output which – in volume – exceeds the tops recorded during the years of the last economic prosperity). By the way, strong base-driven rise in producer prices explains 1-2pp. drop in annual industrial output variation (from obvious reasons the collected data on industrial output are nominal, and then deflated using price indices). All in all deceleration of industrial output was severely affected by base effects (nominal side and real side).

Corporate employment grew in July by 13.6k in absolute numbers what translates into 1.4 y/y growth rate. However, it is worth to note that only 200 (!) workers hired more would be enough to lift the growth rate of employment to 1.5%. Apart form those back-on-the-envelope calculations, employment stays within solid, upward trend which is most likely to continue. Although there is some seasonal boost in the data (as always in services and construction during the summer), seasonally-adjusted figures in coming months should still come in interval 0.1-0.2% m/m. In the year end we expect the growth rate of employment to exceed 2.0% by more than a notch.

Bottom line

Current nominal data bear almost no leading properties (apart form market moving-potential). It is far more important to dig into the real sphere now as it has more forward looking traits. The condition of final demand and marching towards a more mature expansion phase, thriving fiscal stimuli (especially EU-cofinanced infrastructure projects worth at least PLN 32bn this year and over 50bn in 2011) are pointing towards mounting inflationary pressures. However, the timing is crucial. It is possible that positive sentiment in POLGB (tightening of convergence spreads, hopes the EU Commission may exclude the pension funds from calculating public sector debt, and falling yields globally) will last in the coming days and will take the upper hand.

As far as the very front end of the IRS curve and Wibor bets are concerned, the bearish momentum is clearly fading. The prospects for higher inflation in the mid term will not allow the FRAs to fall significantly. However one has to see more of this in the current data to convince the investors that Poland may nominally deconvarge with the EMU and to push the FRAs higher. This is rather unlikely to happen before Autumn.

MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.6	4.2
Inflation rate (%, average)	2.4	4.3	3.5	2.8	3.5
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	3.8	4.0	4.1
Inflation rate (%, average)	3.5	3.3	3.0	2.1	2.6	3.2
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

The week we were not expecting.

Last week started with a surprise reading of CPI which came lower than expected (2.0 against 2.1 expected), we also had a lower reading of wages and industrial production. Some effect on the market had also comment from Hungarian official stating that 9 EU states will back Polish proposal to change definition of “pension funds reform” debt. For Poland it would mean lowering the debt to GDP ratio by some 9pctg points. We also had massive rally in core market bond prices with many of them marking ever lows in terms of yield. All of these events triggered at first some buying interest mainly coming from international community, what turned into full steam rally and big curve flattening on Wednesday. The “ever hated” 0922 bond made 200 cents in price within 4 days, 5y benchmark bond gained 100 cents from levels before CPI reading. Market traded as low as 4.82 in 5y and 4.88 in 10y. 2y10y spread went down to 35 bp as the low. Wednesday marked the high for the week so far, Thursday we saw some profit taking both on bonds and on the receive positions on the IRS. Curve started to a steepen (bullish steepening with 2y going lower in yield).

We were proved wrong on the whole front. Our call was for either higher CPI reading and MPC reacting to that with rate hikes talk, or for fiscal consolidation disappointing market expectations and causing sell off in bonds and adjustment in risk premium. CPI story lost dynamics, fiscal story seems to offer right now little value with risk of second QE and yield hunting environment. We are neutral right now.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	09/12/2008
26 Week T-bills	-	-	4.456%	04/05/2009
52 Week T-bills	22/08/2010	-	3.971%	16/08/2010
2Y T-bond OK1012	01/09/2010	-	4.759%	04/08/2010
5Y T-bond PS0415	01/09/2010	-	5.373%	04/08/2010
10Y T-bond DS1020	15/09/2010	-	5.790%	16/06/2010
20Y T-bond WS0429	15/09/2010	-	6.170%	23/09/2009

Money Market

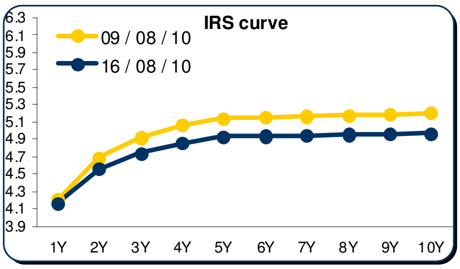
Carry still high

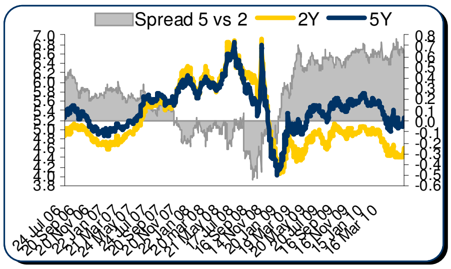
Cost of carry relatively high due to the funds lacking in the system. Probability of cheap end of the reserve is growing, since prolonged time of high carry increases liquidity risk aversion nearby the end of the reserve. Today's open market operation will be definitely crucial.

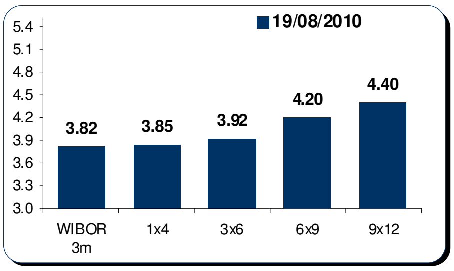
Bullish sentiment still rocks

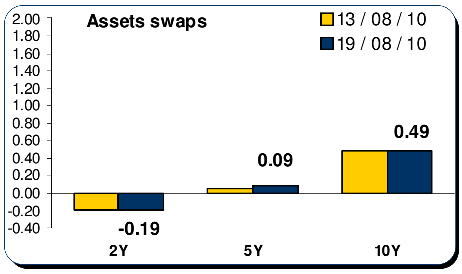
Bullish sentiment still rocks supported by quite interesting set of figures. Wages well below expectations at 2.1% vs 3.7%, industrial output also below expectations at 10.3% vs 12% and only problem for bulls PPI higher at 3.9% vs 3.2%, but this last figure was ignored on the bullish wave. It seems that this sentiment will be undisturbed at least until GDP for 2nd quarter or next CPI release, which may turn on the red light.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

It was a good week for the zloty which was gradually gaining strength against all major currencies. The old pattern of the zloty "gravity alike" strengthening in calm, nonevent environment repeated itself one more time. 4.0200 in EUR/PLN marked the top of the week, with 3,9220 marking the low. The liquidity was rather poor and trading was light .

The historic volatility was once again well below implied one. On the top of it, the zloty is stronger so we have experienced the decrease in ATM s volatility and the risk reversals. The sell off was the especially severe for the front end of the curve. The 1 week was given at 9.5%, 6 month were given at 12.20 in good amount. In general, the front end decreased by 1.0 % and the backend was affected by 0.35 %.

Volatility lower

SPOT

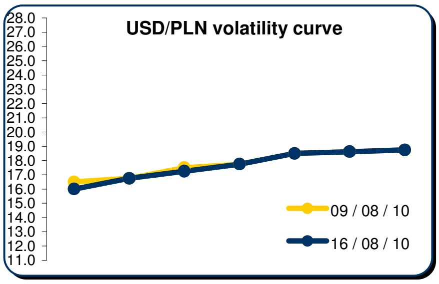
Main supports / resistances:
EUR/PLN: 3.9000 / 4.0500
USD/PLN: 2.9800 / 3.1500

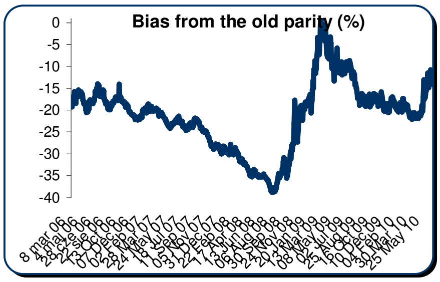
Short-term forecasts:

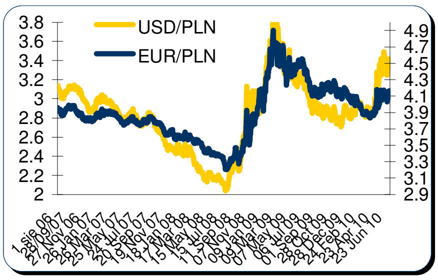
The zloty is slowly approaching this year high at 3.8000, on the back of positive global developments. As the zloty is almost exclusively driven by external factors, one may use the EUR/PLN or USD/PLN (for the brave ones) trades to imply the risk on or risk off strategy. But we do not see any high probability trade at the moment.

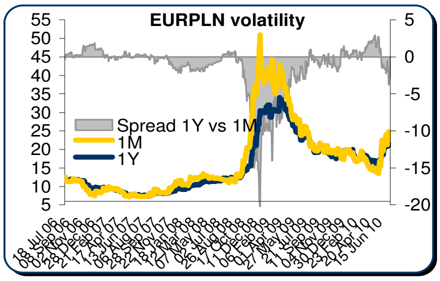
OPTIONS
The volatility is getting softer with stronger zloty, the risk reversals are lower (3.75% 1 year 25d RR in EUR/PLN, 0.35% lower then last week). All the above speks in favor of further gains in Vanna position. We expect the significant jump in volatility, while breaking the 3,80/4,05 range (lower to the downside, higher at the 4,05). Long Vanna is reasonably cheap way to enter that position for a little bit of curve theta and slightly negative gamma (easy to cover at current cheap frontend volatility).

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
12/08/10	3.70%	3.81%	3.90%	3.89%	4.25%	4.13%
13/08/10	3.72%	3.81%	3.87%	3.89%	4.08%	6.59%
16/08/10	3.82%	3.81%	3.87%	6.49%	4.14%	4.14%
17/08/10	3.70%	3.82%	4.01%	3.89%	4.31%	4.14%
18/08/10	3.74%	3.82%	3.87%	3.89%	4.07%	4.14%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
12/08/10	3.86%	4.00%	4.30%	4.54%	4.46%
13/08/10	3.85%	4.00%	4.31%	4.54%	4.50%
16/08/10	3.84%	3.99%	4.28%	4.51%	4.46%
17/08/10	3.85%	3.96%	4.26%	4.48%	4.44%
18/08/10	3.86%	3.97%	4.26%	4.48%	4.44%

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
12/08/10	4.13%	3.70%	4.63%	4.43%	5.09%	5.15%	5.21%	5.70%
13/08/10	6.59%	3.98%	4.60%	4.40%	5.07%	5.12%	5.18%	5.67%
16/08/10	4.14%	3.93%	4.56%	4.37%	4.93%	5.02%	4.97%	5.52%
17/08/10	4.14%	3.92%	4.56%	4.35%	4.88%	4.99%	4.93%	5.48%
18/08/10	4.14%	3.92%	4.54%	4.35%	4.90%	4.99%	4.99%	5.48%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/08/16	11/08/16	96.140	3.97%	1000	2108	917
OK1012	10/08/04	12/10/24	90.185	4.76%	3000	7762	3719
PS0415	10/08/04	15/04/25	100.236	5.43%	2000	4741	2281
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
12/08/10	17.25	18.50	18.90	19.10	3.50	5.35	0.75	0.95
13/08/10	17.00	18.25	18.75	19.00	3.50	5.25	0.75	0.95
16/08/10	16.75	18.00	18.75	18.75	3.25	5.25	0.75	0.95
17/08/10	16.75	17.75	18.50	18.75	3.25	5.00	0.75	0.95
18/08/10	16.75	17.75	18.50	18.75	3.25	5.00	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
12/08/10	3.1215	4.0134	-16.69%
13/08/10	3.1053	3.9941	-16.97%
16/08/10	3.1297	4.0030	-17.53%
17/08/10	3.0810	3.9707	-17.26%
18/08/10	3.0713	3.9535	-17.82%

Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50

Mid-market volatility of vanilla option strategies

Contact Details

BRE BANK SA

Ul. Senatorska 18
00-950 Warszawa
P.O. Box 728
Poland

Reuters Pages: BREX, BREY, and BRET

Bloomberg: BRE

SWIFT: BREXPLPW

www.brebank.pl

Forex (BREX) - FX Spot &Options
Marcin Turkiewicz (+48 22 829 01 84) Marcin.turkiewicz@brebank.pl
Jakub Wiraszka (+48 22 829 01 73)
Tomasz Chmielarski (+48 22 829 01 78)

Fixed Income (BREP) - FRA, IRS, T-Bonds, T-Bills
Łukasz Barwicki (+48 22 829 01 93) Lukasz.barwicki@brebank.pl
Paweł Białczyński (+48 22 829 01 86)

MM (BREP) - MM, FX Swaps
Bartłomiej Małocha (+48 22 829 01 77) Bartlomiej.malocha@brebank.pl
Tomasz Wołosz (+48 22 829 01 74)

Structured Products (BREX)
Jaroslaw Stolarczyk (+48 22 829 01 67) Jaroslaw.stolarczyk@brebank.pl
Jacek Derezinski (+48 22 829 01 69)

Institutional Sales (BRES)
Inga Gaszkowska-Gębska (+48 22 829 12 05)

Research
Ernest Pytlarczyk, PhD, CFA (+48 22 829 01 66) Research@brebank.pl
Marcin Mazurek (+48 22 829 0183)

Financial Markets Department
Phone (+48 22 829 02 03)
Fax (+48 22 829 02 45)

Treasury Department
Phone (+48 22 829 02 02)
Fax (+48 22 829 02 01)

Financial Institutions Department
Phone (+48 22 829 01 20)
Fax (+48 22 829 01 21)

Back Office
Phone (+48 22 829 04 02)
Fax (+48 22 829 04 03)

Custody Services
Phone (+48 22 829 13 50)
Fax

Disclaimer

Distribution and use of this publication

The review note is based on the information available to the public. This review creates exclusively a marketing information as defined in Paragraph 9 Section 1 of the Decree of Minister of Finance dated November 20, 2009 on procedures and conditions to be followed by investment firms and banks mentioned in Article 70 Section 2 of Law on Trading in Financial Instruments dated July 29, 2005 as well as by custody banks. This review note is provided to you for information purposes only and is not intended as advice on any particular matter or as recommendation, offer or solicitation for purchase of sale of any financial instrument and should not be taken as such. BRE Bank SA, its directors, officers, executives, managers, servants or agents expressly disclaim all liability to any person in respect of any-thing, and in respect of the consequences of anything, done or omitted to be done, wholly or partly, in reliance upon the whole or any part of the contents of this review note. The opinions and estimates contained herein reflect the current judgment of the author(s) on the date of this document and are subject to change without notice. The opinions pointed in review do not necessarily correspond to the opinions of BRE Bank SA. The past performance of financial instruments is not indicative of future results. No assurance can be given that any financial instrument or issuer described herein would yield favourable investment results. BRE Bank and/or its principals or employees may have a long or short position or may transact in the financial instrument(s) and/or securities referred to herein or may trade in such financial instruments with other customers on a principal basis. No client or other reader should act or refrain from acting on the basis on any matter contained in it without taking specific independent professional advice on the particular facts and circumstances in issue. Copyright protection exists in this publication and it may not be, even partially, reproduced of distributed without the prior written agreement with BRE Bank SA.