FINANCIAL MARKETS DEPARTMENT

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WARSAW, SEPTEMBER 3, 2010

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 3rd 2010 to September 9th 2010

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

In Focus / Macroeconomics

Deceiving MPC statement. Mood among rate-setters much more hawkish.

Recent MPC statement conveyed the message everything was just as before the "vacation" rate-setters enjoyed by more than 50 days since June meeting, including wait-and-see approach and broadly neutral balance of inflation risks. However, it seems we have all been deceived. It is now a common knowledge that out-of-the-blue there was a vote on a hike in August. Hawkish comments uttered just after the better GDP release (3.5% vs 3.2% expected) confirmed the emerging picture, that something has changed…behind the scenes.

GDP acceleration.

Polish economy grew in Q2 by 3.5% y/y after 3.0% in the previous quarter. The main driving force was domestic demand which accelerated to 3.8% y/y from 2.3% y/y a quarter ago. The acceleration stems from 3 factors: solid inventories formation which added +1.8pp., acceleration of private consumption to 3.0% y/y, and a solid rebound of fixed capital formation (although private investment is still in the woods, infrastructure spending made up almost the whole dip suffered in Q1 on weather related factors). Net exports contribution softened towards -0.3pp bringing the GDP figure (compared to internal demand) down to 3.5% y/y. The publication confirms our long endorsed view, that internal demand (even after controlling for non-market infrastructure investment) is supported by cyclical factors, and is unlikely to fade in the coming quarters. We thus expect the GDP growth to stay close to 3.5% in coming quarters with possible acceleration in 2011, driven primarily by non-market forces embodied in record high infrastructure investment.

Such a view finds confirmation in the fresh PMI data. Overall, the figure came much higher than expected, but what is interesting is the fact that domestic orders were able to offset the fall in orders from abroad, confirming the strength of internal demand (the fact we emphasize in our research).

MPC comments…and the emerging consensus?

It seems now that at least 3-4 MPC members (Bratkowski, Zielinska-Głebocka, Glapinski, Rzonca?) favor the idea of a one-off interest rate to anchor inflation expectations. The idea carries a lot of advantages for the MPC. First of all, it would be a signal the MPC is on the watch and ready to act to counter inflation and inflation expectations (it seems important feature of MPC behavior right now as some commentators bluntly claim the body has recently lost some of the long-built credibility). Secondly, properly communicated, such a movement does not carry a significant risk of abrupt zloty appreciation (which would be rather avoided as MPC is still overly focused on growth and exports). Thirdly, "normalizing" interest rates now gives MPC some room to put off the cycle, should ECB stay idle form longer (a strategy aimed ta keeping interest rate differential in check, thereby protecting zloty from more rapid appreciation).

Taking these arguments into consideration we think the risk of rate hike in coming months has substantially increased. One cannot really rule out such a vote already in September although CPI inflation stays relatively low (according to the Ministry of Finance forecast it accelerated only slightly to 2.1%), fears concerning the global economy (this is an important decision factor according to Bratkowski, more important than October inflation projection) have not completely subsided and the government presented budget draft with a deficit even lower than presented in the mid-term plan (central deficit at PLN 40 bn). There are more arguments in favor of a rate hike in October.

1) Starting from September, CPI inflation is going to accelerate sharply on food prices. In the year end it is likely to hit 3.0% (or even surpass it),

2) The sharp rise of food prices may easily translate into higher consumer expectations (so far the surge in inflation expectations from 2.2% to 2.7% is explained by the reaction of consumers to the announced VAT hikes; there is a plenty of room to go higher then),

3) Some doubts concerning the global economy are going to slowly fade away,

4) Domestic economy is not going to lost momentum as internal demand stays an important driver of growth, labor market is tightening and soon it may be able to generate inflationary pressures; on the cost side it seems enterprises need only an meaningful incentive to pass higher prices to consumers.

As a bottom line it should be stressed that seemingly leading scenario of preventive hikes may translate into a fully-fledged beginning of a cycle of monetary tightening if only MPC members wait enough long to see the mid-term inflation perspectives are deteriorating not only because of shifting the Phillips curve on higher inflation expectations, but also on the back of cyclically stronger domestic economy. Either the scenario of a preventive strike, or the beginning of monetary tightening offer good opportunity at the FRA curve. The gap between 3M expected inflation and current reading gives a fair opportunity to pay short rates just after the official inflation data release. As it is the case in typical EM economies, an indication of monetary tightening, regardless of its nature, is not a good news for bond holders.

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	4.50

Indicator	2009		2010			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	1.7	3.1	3.0	3.5	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 changes from the last release with arrows showing the direction of changes

Fixed Income

At the crossroads

Last week didn't bring any significant change in a yield curve. Though we could observe a slight upside trend, the market stayed quite calm without any substantial turnover. The short end of a curve moved up about 5bp after the market was announced about the interest rate hike motion voted at the August RPP meeting. It seems however that the October and December-maturing FRA contracts have priced at least 80% of the 25bp hike probability and had no further scope to move up especially when the Wibors had no intention to follow. The 2x5s FRA maturing after October's RPP meeting traded up at 3.96% and 3x6s FRA maturing after November's meeting traded at 4.03% respectively (15 and 22 basis points above the current 3M Wibor rate).

The longer end of a curve was trying to follow the global mood moving up slightly after the better than expected US ISM data and rapid correction on the BUND market. What's quite interesting the shape of a curve didn't much changed even though we could see some interest to pay the spreads in 2y10y and 5y10y sector (it trades around 36 and around flat respectively still). On the bond market, the Ministry of Finance sold successfully the PLN 4 bln of OK1012 2y benchmark treasury bonds on Wednesday at the quite satisfactory PLN 6.6 bln demand.

Assuming, the market seems to reach its crossroads and needs to have any real trigger to find its way. The FRA market is quite balanced and have no real room to trade at the moment while the longer end might be more vulnerable to the upside following the core markets especially when it trades around its year's lows now.

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	8/30/2010	-	3.939%	8/30/2010
2Y T-bond OK1012	10/6/2010	-	4.672%	9/1/2010
5Y T-bond PS0415	9/8/2010	-	5.373%	8/4/2010
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

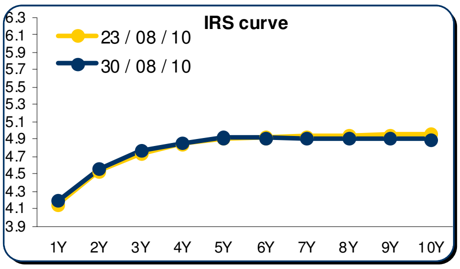
Carry back above 3%

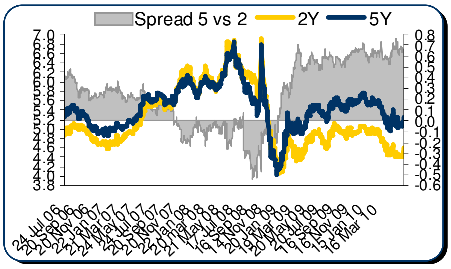
Easy beginning of the month and of the reserve requirement settlement period. Cost of carry stable just above 3%. Probably it will stay like this for another week.

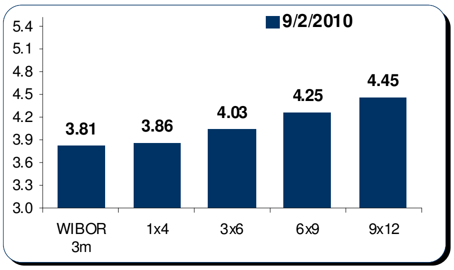
Better GDP brings back rate hike expectations

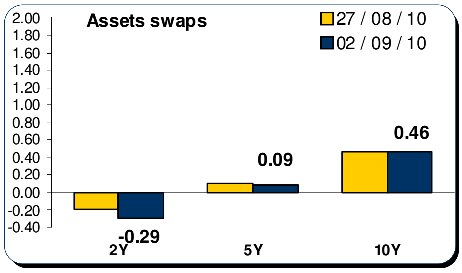
Bit better then expected GDP for 2nd quarter ruined the mood for bulls and again expectations for the rate hike this year became an important factor. It was strengthen by the fact that rate hike was being voted during the last MPC meeting. Therefore the CPI forecast by MinFin at 2.1% remained neutral from the IR perspective. Waiting for next figures and watching the currency will be the main activity unless something global changes it.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty boxed in tight range

Zloty has closed last week at 3.97'is levels, and so has done this one. The range of the week was marked by 3.9630-4.0170. All this week's trading sessions were dominated by the US ISM data. On Monday, fears of low number, and as a result increased probability of double dip, has provoked some P/T on long PLN positions and EURPLN has hit 4.0170 top. On Wednesday, better than expected, announcement (ISM) has changed the global picture and also has improved performance of the Zloty.

Volatility untouched

Underlying is trading very same range since early August and realized volatility on back of that fact calculates at about 10% - close to short end implied. As a result implied curve was traded at nearly, the same shape, this week ranges were : 1M 10.8-11.15, 3M 11.75-12.0, while 1Y stays at 12.5. Other Zloty benchmarks were traded: 3M 25D EURPLN RR at 3.25%, 3M EURPLN vs. USDPLN spread at 6.5%.

Short-term forecasts:

SPOT

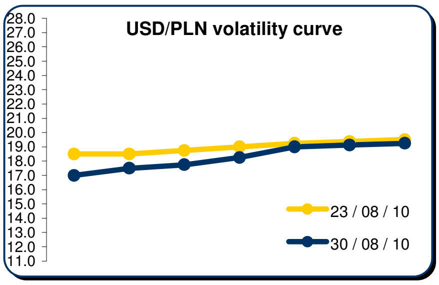
Main supports / resistances:
EUR/PLN: 3.9000 / 4.0500
USD/PLN: 2.9800. / 3.1500

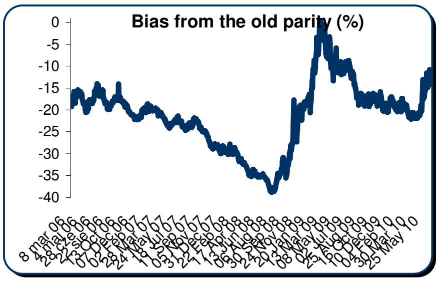
As the Zloty is almost exclusively driven by external factors, and those has improved a bit we slightly change momentum for PLN for neutral/positive. The ultimate target may be set at 3.90 but be prepared for reversals with 4.06 an important level.

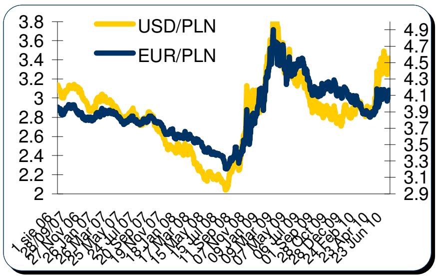
OPTIONS
Historically Zloty gains are much more modest than losses. So if one expects Zloty appreciation, selling gamma is a logical strategy. Zloty implied curve is highly correlated with current spot

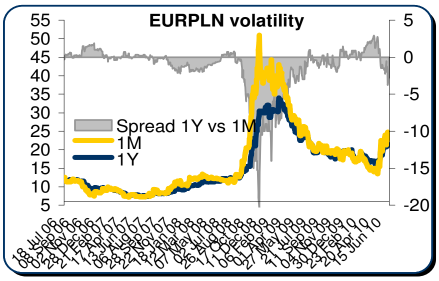
level (3M vol about 0.85). All the above plus current implied level makes it possible for Vanna to rise. We expect the significant jump in volatility, while breaking the 3.80/4.05 range (lower to the downside, higher at the 4.05). Long Vanna is reasonably cheap way to enter that position for a little bit of curve theta and slightly negative gamma (easy to cover at current cheap front-end volatility) .

FX CHARTS









MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M FXSW	3M WIBOR	6M FXSW	6M WIBOR	1Y FXSW	1Y WIBOR
26/08/10	3.70%	3.81%	3.93%	3.89%	4.15%	4.14%
27/08/10	3.70%	3.81%	3.90%	3.89%	4.15%	6.59%
30/08/10	3.75%	3.81%	3.90%	6.49%	4.15%	4.15%
31/08/10	3.75%	3.81%	3.87%	3.90%	4.14%	4.14%
01/09/10	3.70%	3.81%	3.90%	3.90%	4.15%	4.14%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
26/08/10	3.85%	3.96%	4.17%	4.37%	4.35%
27/08/10	3.85%	3.94%	4.17%	4.37%	4.34%
30/08/10	3.85%	3.95%	4.19%	4.39%	4.37%
31/08/10	3.85%	3.97%	4.19%	4.39%	4.35%
01/09/10	3.88%	4.00%	4.25%	4.43%	4.37%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y WIBOR	1Y TB	2Y IRS	2Y OK0112	5Y IRS	5Y PS0511	10Y IRS	10Y DS1017
26/08/10	4.14%	3.91%	4.51%	4.33%	4.87%	4.94%	4.91%	5.32%
27/08/10	6.59%	3.91%	4.53%	4.34%	4.89%	4.99%	4.88%	5.35%
30/08/10	4.15%	3.94%	4.56%	4.30%	4.92%	5.03%	4.90%	5.38%
31/08/10	4.14%	3.95%	4.60%	4.34%	4.95%	5.07%	4.96%	5.42%
01/09/10	4.14%	3.95%	4.60%	4.31%	5.00%	5.09%	5.03%	5.42%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/08/30	11/08/30	96.170	3.94%	700	2592	550
OK1012	10/09/01	12/10/24	90.670	4.67%	4000	6603	4000
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

date	USD/PLN 0-delta stradle 1M	3M	6M	1Y	25-delta RR 1M	25-delta RR 1Y	25-delta FLY 1M	25-delta FLY 1Y
26/08/10	17.80	18.80	19.10	19.40	3.75	5.50	0.75	0.95
27/08/10	17.30	18.30	18.85	19.15	3.75	5.50	0.75	0.95
30/08/10	17.30	18.30	18.85	19.15	3.75	5.50	0.75	0.95
31/08/10	17.65	18.50	19.00	19.25	4.00	5.75	0.75	0.95
01/09/10	17.50	18.25	19.00	19.25	4.00	5.75	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
26/08/10	3.1452	3.9927	-17.23%
27/08/10	3.1304	3.9810	-16.84%
30/08/10	3.1226	3.9755	-17.78%
31/08/10	3.1583	4.0038	-18.10%
01/09/10	3.1285	3.9922	-17.98%

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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