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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 10th 2010 to September 16th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A mln EUR	Sep 10	Jul	**-1200**	-880	-1004	Lower EU current transfer (250mld from 1200 total), high EU contribution. Lower growth of industrial output, moderate auto production and low durable goods output speak in favor of lower imports and exports.
M3 supply y/y	Sep 14	Aug	**9.2%**	8.6%	7.8%	Low base form the last year.
CPI inflation y/y	Sep 14	Aug	**2.2%**	2.2%	2.0%	MinFin's forecast at 2.1%. However, we bet on a higher reading basing on business tendency indicators.
Employment y/y	Sep 16	Aug	**1.6%**	1.7%	1.4%	Lower business tendency indicators, Growing base connected with a turnaround in the labor market last year. Monthly growth close to 0.1% m/m, seasonal hiring flat or reversed.
Wages y/y	Sep 16	Aug	**4.7%**	4.0%	2.1%	One working day more on annual basis. We were misled by the KGHM bonus payments, expected in August but already paid out in September.

In Focus / Macroeconomics

2011 budget draft - revenue seeking, not a slight sign of a reform

After wide-spread rumors on the draft budget for 2011 commented in the press, we finally got the whole document. The government expects to reap PLN 273.3bn of income and to spend PLN 313.4bn. Compared to this year's expected figures, income is expected to increase by 9.6% and spending by 4.1%.

The income side of the budget relies on quite conservative assumptions: 3.5% GDP growth, 2.3% CPI expansion and 3.3% bigger labor fund (growth of employment times real wage growth). The fresh issues in income side are minor systemic changes in VAT tax (ad hoc temporary increase by 1pp.) and quite optimistic assumptions on expected dividend payments (hard to negate the plan as the Treasury Ministry has powers to push for the dividend it needs). The spending side seems thrifty, although it is sometimes backed by dubious assumptions. The most striking case is a lower outflow for the Social Security Fund (FUS) than a year ago – to this end the government accepted to wind down some of the reserves and cuts in social benefits (funeral relief); for some reason the same story applies to agricultural security fund (KRUS), which used to be money-sucking fund. Lower growth of wages was also achieved through wage freeze in public administrations (excluding teachers to whom the government owes promised pay rises).

The accompanying EU budget is going to be set with a deficit of PLN 16.2bn. Netting out the privatization revenues with the transfer to open pension funds leaves the central budget net borrowing needs at 72.9bn (one should bear in mind that the government lowered the borrowing needs by adding to the revenue side a planned savings stemming from better management of liquidity, PLN 19.8bn sharp). Along with the other deficit-generating entities within the whole government sector (local authorities, to some extent the Road Fund) the net borrowing needs of the whole sector are likely to be much higher (at least +20bn); gross borrowing needs of the whole sector are estimated at PLN 171.5bn.

At first sight, the deficit figure itself is positive news (the government has made it go even lower than in the previous announced mid-term plan). However, one cannot resist a feeling that the budget was zipped by one-off measures, taking deliberately such a social-neutral form just before the local (2010) and parliamentary elections (2011). And it seems not the point right now as investors are slowly changing focus from liquidity measures (in which this budget draft seems a masterpiece) to long-term structural issues (almost non-existent in the bill…). It will not be enough though to trigger a sell on Polish bonds as Poland still shines in terms of GDP growth and global reallocation towards higher yielding emerging markets' assets seems far from being over. Investors (and rating agencies as well) are focused on 2012 onwards when the temporary impulses for growth will fade, and the problem of ageing population and rising public debt will become a serious issue.

And as for the weakest points of the drafts, there are the following:
- no systemic changes which may affect the growth of expenditure side (pension reform, agricultural pension system etc.),
- a tendency of the government to move some entities out from the central budget to the general government sector, where it has less room for control; we end up in a situation in which frequently published central deficit is close to 3% of GDP, whereas the opaque government sector generates 8% deficit and in a big ticket announcement – e. g. in 2009,
- dubious size of the subsidy to the Social Security Fund (FUS); it is possible that the ensuing deficit will be covered by bank loans.

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	**4.00↑**	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	**4.00↑**

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

Fixed Income

Front end pushing higher

Volatility increased a little on the FI market over last week. Beginning of the week brought some correction of previous weakening move, mainly based on some rebound on core markets. However that didn't last long, and rates pushed back higher to previous week's highs. That also resulted in some flattening of the curve, both in 2y5y and 5y10y sectors. Front end of the curve was definitely under biggest pressure, as market has already fully priced in 25bp hike within next two months and a small probability of even more tightening. 2x5s and 3x6s FRA traded at 4.06% i 4.13% respectively. Yet spot Wibor rates didn't move at all, which somehow limits room for further weakening.

Macro data to confirm the move

Ministry of Finance has successfully placed 3bio of 5y benchmark bond on Wednesday, with b/c ratio at 2.5

Next week's announcement of economic data will be the key for further direction for the market, especially for the front end of the curve. Our estimates suggest that data should confirm what's currently priced in in the curve. However as rate tightening scenario has been quite repriced over past week, reading worse than currently expected, especially in terms of inflation, could easily result in some pullback on the curve. Longer maturities will likely continue to follow global sentiment.

It seems that the tendencies we've observed this week, i.e. pressure on the front end and flatter curve are likely to continue, as long as the find confirmation in the economic data, and possibly some more hawkishness from the MPC.

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	9/13/2010	-	3.939%	8/30/2010
2Y T-bond OK1012	10/6/2010	-	4.672%	9/1/2010
5Y T-bond PS0415	10/13/2010	-	5.431%	9/6/2010
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

Repo with the central bank looses any meaning

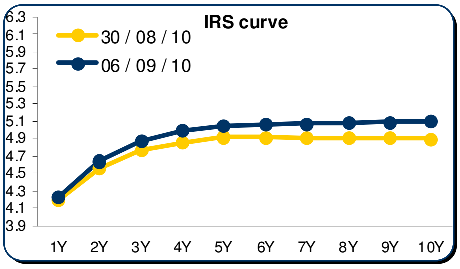
Cost of carry stable just below 3%. Surplus of the cash in the system as of now reaches 4 billion pln and tomorrow the central bank will certainly try to sterilize it during the open market operation. We can expect the supply of the money bills around 85 billion pln.

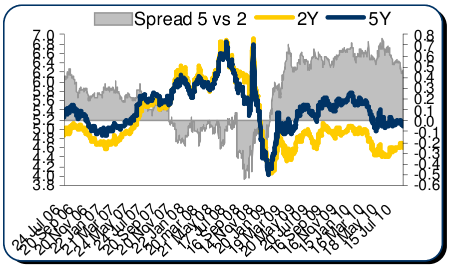
3M repo again only symbolic in size (100 mio pln) and even more symbolic in demand (49 mio pln). Right now there is only 650 mio pln coming from the previous auctions. 400 mio out of this amount is maturing next week.

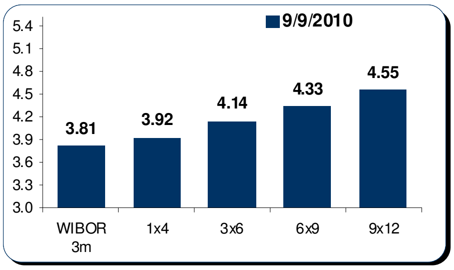
50 bps prevention hike in market scenario now

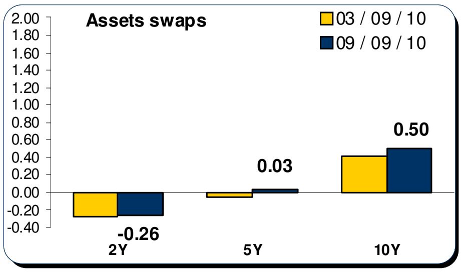
This week bearish sentiment exploded after the rumour that 50 bps prevention hike can be done soon just to avoid the longer cycle. If this would be the case the short end has still long way to go. It would be quite bullish for bonds though.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stable

This week Zloty has been traded in narrow 4 big figures range, with bottom marked at 3.92 and top at 3.96. When compared to major markets one may say: surprisingly stable. Numerical it is 1% of EURPLN's range against to 2% range of EURUSD and 3% of EURJPY crosses. It may incline brave thesis that Zloty has gained some immunity for external factors. At least for now. What was behind core markets volatility? Lowering European bonds valuation and U.S. Beige Book announcement confirming lower probability of double-dip.

Volatility bit lower

Again, combination of lower spot furthermore traded in narrow range (weekly historical volatility about 6%) and mixed outer signals left curve almost untouched. Short end has been traded in 10.5-11% range (1M), and we have notice slight slip on long end – 1Y from 12.35 to 12.1. Other Zloty benchmarks were traded: 3M 25D EURPLN RR at 3.0%, 3M EURPLN vs. USDPLN spread at 6.75%.

Short-term forecasts:

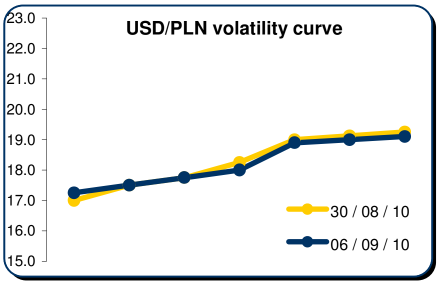
SPOT

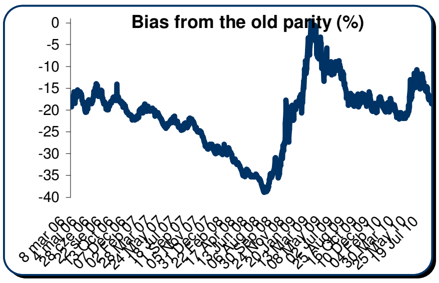
Main supports / resistances:
EUR/PLN: 3.9000 / 4.0500
USD/PLN: 2.9800 / 3.1500

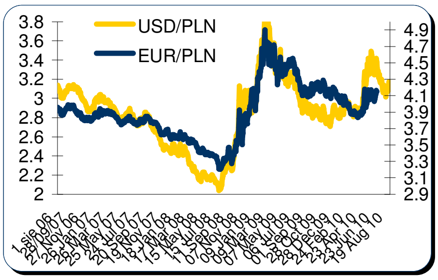
External factors, usually only PLN driver these days, have given some mixed signals. Anyhow, so far we see momentum for PLN as neutral/positive. Important technical levels almost unchanged: 4.03, 4.06 and 3.90.

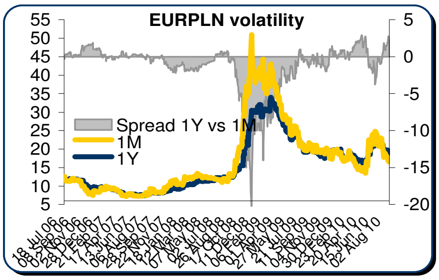
OPTIONS
We have written: "Historically Zloty gains are much softer than losses and that way we see potential Zloty appreciation. Gamma deemed to fall." Nothing to add here. Moving market is the trigger which the long vanna needs. Although it seems stable for now, we feel that global sentiment, which stays vulnerable, will provide enough chances to vega hedge in future. We expect the significant jump in volatility, while breaking the 3.80/4.05 range (lower to the downside, higher at the 4.05).

FX CHARTS


USD/PLN volatility curve
30 / 08 / 10
06 / 09 / 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
02/09/10	3.69%	3.81%	3.90%	3.90%	4.15%	4.14%
03/09/10	3.68%	3.81%	3.89%	3.90%	4.11%	6.59%
06/09/10	3.68%	3.81%	3.88%	6.49%	4.10%	4.14%
07/09/10	3.71%	3.81%	3.87%	3.90%	4.06%	4.14%
08/09/10	3.71%	3.81%	3.86%	3.89%	4.11%	4.14%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
02/09/10	3.86%	4.02%	4.25%	4.46%	4.43%
03/09/10	3.87%	4.03%	4.26%	4.49%	4.43%
06/09/10	3.86%	4.03%	4.25%	4.45%	4.42%
07/09/10	3.89%	4.06%	4.29%	4.50%	4.45%
08/09/10	3.86%	4.07%	4.30%	4.51%	4.45%

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
02/09/10	4.14%	3.94%	4.61%	4.32%	5.01%	5.10%	5.02%	5.48%
03/09/10	6.59%	3.97%	4.63%	4.35%	5.04%	4.99%	5.07%	5.48%
06/09/10	4.14%	3.94%	4.64%	4.35%	5.05%	4.99%	5.10%	5.48%
07/09/10	4.14%	3.97%	4.57%	4.35%	4.97%	4.99%	4.97%	5.48%
08/09/10	4.14%	3.97%	4.61%	4.35%	4.96%	4.99%	4.98%	5.48%

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	10/08/08	15/04/25	101.123	5.21%	3000	7500	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
02/09/10	17.50	18.25	19.00	19.25	3.75	5.50	0.75	0.95
03/09/10	17.25	18.25	18.90	19.10	3.40	5.65	0.75	0.95
06/09/10	17.25	18.25	18.75	19.00	3.90	5.65	0.75	0.95
07/09/10	17.75	18.00	18.50	18.75	3.90	5.65	0.75	0.95
08/09/10	17.50	18.00	18.90	19.10	3.65	5.15	0.75	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
02/09/10	3.0952	3.9659	-17.43%
03/09/10	3.0895	3.9635	-16.99%
06/09/10	3.0450	3.9279	-16.25%
07/09/10	3.0943	3.9495	-16.72%
08/09/10	3.1170	3.9494	-16.79%

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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