



## POLAND WEEKLY REVIEW

### MACROECONOMICS AND FINANCIAL MARKETS

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#### PREVIEW: The week of September 24<sup>th</sup> 2010 to September 30<sup>th</sup> 2010

Indicator	Date of release	Pe-riod	BRE forecast	Consensus	Last	Comment
Retail sales	Sep 24	Aug	6.1%	5.9%	3.9%	Decent growth of auto sales compared with one working day more would make a good reading, especially when it seem that after-flood wealth restoration have just started.
MPC decision	Sep 29	-	4.00%	3.50%	3.50%	After the 50bp. hike motion submitted in August there is a good chance for repetition. <b>Although we call for 50bp, it is more a reflection of risks than a certainty.</b>

## In Focus / Macroeconomics

### General government deficit in 2010 at PLN 100bn plus

Out of the blue, FinMin Rostowski announced that Polish general government deficit may top 100bn this year. The figure contrasts with the 80bn estimate included in the mid-term Fiscal Strategy released in August! Mr. Rostowski blame local communities for this kind of overshooting claiming that the government has virtually no control over their spending, the point we often emphasized in our reports.

Higher fiscal deficit this year automatically translates into higher public debt to GDP ratio which already this year nears 55% mark (all depends on zloty exchange rate and thus foreign debt zloty value at the end of year). It also makes the risk of breaching the limit in the next years much more pronounced. The lack of serious fiscal consolidation and the mounting mid-term fiscal problems, so far masked well by the government's accounting tricks, seem to attract more and more attention now (see very critical articles by former Deputy FinMin Gomułka and former Deputy Head of the NBP Rybinski in the local press).

We stick to our opinion that the fiscal strategy for 2011 hinges on one-off measures and the mid-term plan is not backed by any legislative actions. Once betting on Hungarian type of scenario one should however take into account such factors as an access of Polish government to the FCL, continuous inflow of foreign portfolio capital (real money in vast majority), and still positive sentiment towards Polish assets justified by positive economic growth rates. That is why we see a fiscal risk more as a mid-term risk than an immediate threat for financial markets.

### Surprising MPC „Minutes”. 50bp hike discussed already in August.

We have impression that the discussion at the last MPC meeting was more than usually overload with lots of treads and different opinions. It seems the consensus drifts towards stability of Polish GDP growth, or even a marginal acceleration of the economy. Although the current state of low inflation was commonly acknowledged, there were different views concerning the price developments in the future. MPC members pointed out that GDP growth is positive but moderate and unit labor costs remain low. On the other hand forecast inflation seems to systematically under-shot actual price developments and inflation expectations may rise on the back of VAT hikes and the situation in food and energy markets.

The majority within the MPC seems to be critical towards fiscal policy and the lack of structural reforms. Some MPC members indicated even the risk of rising inflation pressure on the back of this fact. A lot of space and effort was devoted to the links between monetary tightening and the PLN exchange rate. It seems the majority of MPC is still concerned that rising rate disparity may make zloty appreciate, especially in the low-rate environment abroad. However, this may not be the case when sentiment towards Polish debt worsens (with relation to disappointing fiscal consolidation plan). The most interesting part of the “Minutes” was, in our opinion, the passage concerning the closing of output gap (as the growth of potential weakened relative to recent years, and the process is not going to reverse owing to the lack of current private investment) and ensuing need for normalization of interest rate to make it more in-line with the growth rate of the economy. The submitted motions (50bp. hike and 50bp. increase in the reserve rate requirement) failed to gain support.

Minutes and the vote on 50bps hike come as a surprise for the markets. After their release FRA curve shifted by 8bps, bonds remained broadly unchanged. It seems investors perceive the rate hike as a kind of pre-emptive strike, not the initiation of the tightening cycle. We see a significant risk of monetary tightening in September (50bps hike). Such a move would support the MPC's credibility and suggest the body has recently worked out a consistent strategy in a wake of mounting future inflationary risks. Pre-emptive rate hike would also be a way to make up for a higher risk premium needed due to deteriorating fiscal outlook and weaker zloty.

**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	<b>4.00↑</b>	4.00

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

**Fixed Income**

*50bp hike motion failed once. Will the next one succeed?*

The headline of last week was publication of "Minutes" from August MPC meeting. While most of the week bonds and rates traded in very tight range following risk on/risk off sentiment, the big change happened when the fact about motion about 50bp hike saw the light. Till that moment market was expecting small 25bp adjustment to happen sometime during 4Q 2010. Market reaction on the front end was very sharp, 2x5 and 3x6 FRA traded some 10bp higher than previous day close, curve flattened again with 2y bonds underperforming the rest of the curve. From other highlights, Ministry of Finance Rostowski "hinted" that government sector deficit will be higher than 100 bio PLN. The discussion about public finances is starting to gain pace as Rybinski, Gomulka and Jankowiak are becoming very critical towards the government. On the other side, Moody's stated the observed slight upward pressure on Polish rating. All in all, we expect MPC to deliver preemptive strike in not so distant future (October the latest) and most likely we will see some deterioration of sentiment on the longer end of the bond curve. The trigger can come from euro zone peripherals, which trade very volatile and are close to blow up levels. However, possibly smaller issuances in Q4 should have stabilizing effect on the long maturities.

**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	9/27/2010	-	3.939%	9/20/2010
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	10/20/2010	-	5.456%	9/15/2010
20Y T-bond WS0429	10/20/2010	-	6.170%	9/15/2010

**Money Market**

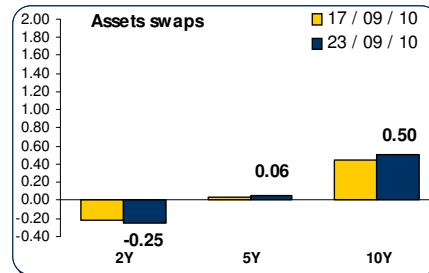
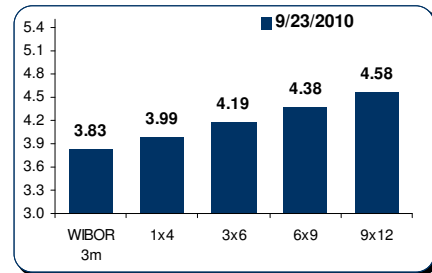
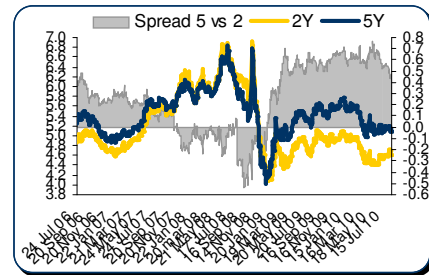
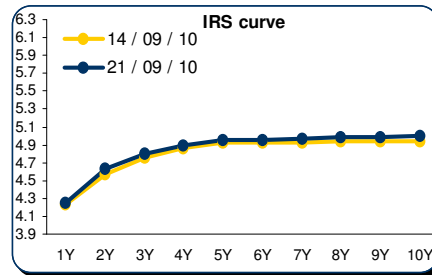
*Again demand lower than CB offer*

Last Friday Central Bank offered PLN 83.5bln bills and banks again didn't buy all papers from the offer- only 81bln. ( It was 5th time in a row banks demand was lower than NBP offer). Therefore there was approx. 5 bln cash surplus in the system and short term depo rates were similar to those last week. Next Wednesday is the last day in this reserve requirements period. Thus we expected today's tender to be underbid as well and beginning of next week to be cheap.

*T-bills yields down at the tender*

On Monday MinFin offered 52-week T-bills for the first time in this month. Banks demand was almost PLN 3.5bln and MinFin sold 600 million PLN bills at an av. yield 3.904% (against 3.939% during last tender).

**FIXED INCOME & MONEY MARKET CHARTS**



**Foreign Exchange**

*Zloty weaker*

Pros: good/neutral global sentiment, higher expectations a rate hike. Cons: officially announced public deficit, USDPLN cross demand (5months low), worse local sentiment. Result: EURPLN has broken out of 3.92/3.96 range. Just after trading this week's low at 3.93 EURPLN has headed up to 3.9880 top. Correlation with usual benchmarks (DJI, EURJPY, EURUSD) still prints low values (near zero), while with CE3 region is closer to 1.0.

*Volatility higher*

Volatility curve is traded higher, especially short end. Both ATM and smile has wrote down noticeable jump – 1M from 10.1 to 10.6, 1M 25D RR from 2.0 to 2.5. Longer end stays hardly untouched. What is performance of underlying in realized volatility wise? Last four weeks time series looks like: 6%, 5%, 6%, 6.8%. Inconsistency, one may say. But we see here more influence of hedging long PLN positions role.

**Short-term forecasts:**

SPOT

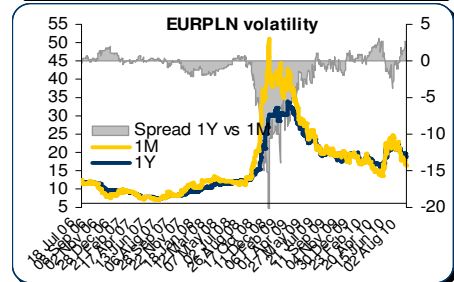
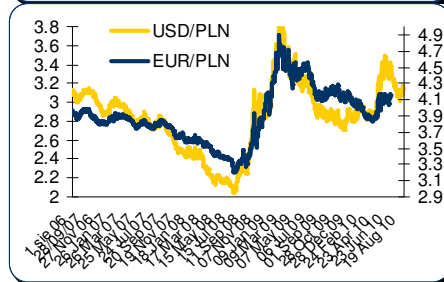
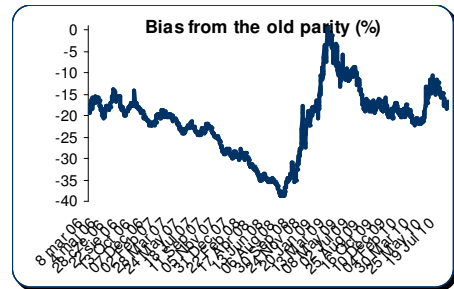
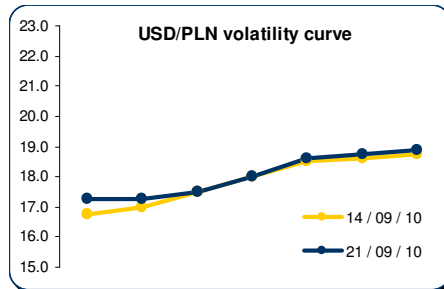
Main supports / resistances:  
 EUR/PLN: 3.9000 / 4.0500  
 USD/PLN: 2.9800 / 3.1500

So far we hardly see fundamental reason to continue trading weaker side of PLN. Minor resistance is at 3.9970/4.000. One may exploit this fact going short EURPLN at 4.0 with S/L above 4.03 and P/T at 3.90.

OPTIONS

Despite weaker PLN and higher implied vols, realized volatility is on our side. We think the gamma has still downward potential.

**FX CHARTS**



**MARKET PRICES UPDATE****MONEY MARKET RATES**

## Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WBOR	FXSW	WBOR	FXSW	WBOR
17/09/10	3.70%	3.82%	3.90%	3.92%	4.15%	4.16%
20/09/10	3.73%	3.82%	3.92%	3.92%	4.11%	6.59%
21/09/10	3.71%	3.83%	3.93%	6.49%	4.15%	4.15%
22/09/10	3.76%	3.83%	3.99%	3.93%	4.20%	4.15%
23/09/10	3.75%	3.83%	3.94%	3.93%	4.18%	4.15%

**FRA MARKET RATES**

## FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
17/09/10	3.90%	4.11%	4.31%	4.51%	4.48%
20/09/10	3.92%	4.12%	4.33%	4.50%	4.48%
21/09/10	3.88%	4.13%	4.31%	4.51%	4.49%
22/09/10	3.91%	4.11%	4.31%	4.50%	4.48%
23/09/10	3.90%	4.11%	4.32%	4.52%	4.50%

**FIXED INCOME MARKET RATES**

## Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WBOR	TB	IRS	OK0112	IRS	PS0511	IRS	DS1017
17/09/10	4.16%	3.92%	4.59%	4.37%	4.92%	4.96%	4.97%	5.41%
20/09/10	6.59%	3.91%	4.61%	4.36%	4.93%	4.96%	4.99%	5.42%
21/09/10	4.15%	3.91%	4.63%	4.36%	4.95%	4.96%	5.00%	5.43%
22/09/10	4.15%	3.91%	4.61%	4.36%	4.90%	4.96%	4.93%	5.43%
23/09/10	4.15%	3.91%	4.61%	4.36%	4.90%	4.96%	4.93%	5.43%

**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**

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
17/09/10	16.75	17.75	18.50	18.75	3.75	5.00	0.75	0.90
20/09/10	16.75	17.75	18.50	18.75	3.45	5.00	0.75	0.90
21/09/10	16.50	17.75	18.50	18.75	3.45	5.00	0.75	0.90
22/09/10	16.50	17.65	18.30	18.60	3.75	5.05	0.75	0.90
23/09/10	17.25	18.00	18.60	18.90	3.75	5.05	0.75	0.90

**PLN SPOT PERFORMANCE**

## PLN spot performance

date	USD/PLN	EUR/PLN	bias
17/09/10	3.0079	3.9545	-18.70%
20/09/10	3.0156	3.9506	-17.88%
21/09/10	3.0053	3.9458	-17.62%
22/09/10	2.9636	3.9427	-17.92%
23/09/10	2.9853	3.9813	-18.18%

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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