FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of October 8th 2010 to October 14th 2010

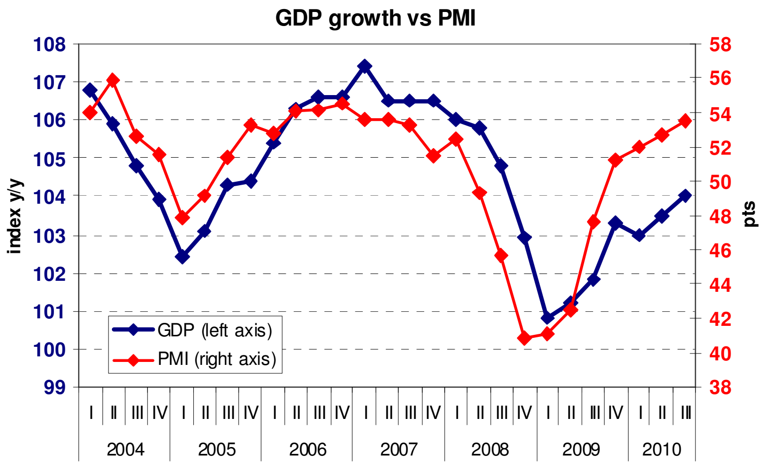
Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A Balance mln EUR	12 Oct	Aug	**-1493**	-1077	-1539	Exports +9544mln EUR, Imports 10383mln EUR. Industrial output and retail sales relatively strong compared with the last 2 years, weak compared to 2006-2007. Low inflow connected with coupon payments on public debt. Low transfer from EU.
CPI Inflation y/y	13 Oct	Sep	**2.4%**	2.3%	2.0%	Food prices well above the seasonal pattern. The acceleration of price expectations (food industry) matching exactly the pattern observed in 2007. Core inflation easing to 1.1% y/y.
M3 Supply y/y	14 Oct	Sep	**8.4%**	9.0%	9.6%	High base from the last year.

In Focus / Macroeconomics

CPI inflation forecast „conservative" enough. PMI marking new peaks.

The Ministry of Finance announced it expected CPI to top 2.3% in September. Contrary to earlier MF actions, this time the forecast was not accompanied by at least brief description of relevant components (the most interesting issue is the extent the CPI is driven by food prices). We feel quite comfortable with this forecast as MF makes use of accurate (close to GUS) estimates of food prices from the first half of the month concerned. As there were no turnaround in food prices (monitored at the level of marketplaces and wholesale) in the second half of the month, **we think it is possible to reach 2.4% y/y in official GUS estimate.** We confirm our view it is possible for CPI to accelerate further in coming months. Starting from 2011, we also expect core CPI to rise (direct effect of solid GDP growth and strong labor market), making the "on-hold" MPC stance harder and harder to explain and communicate.

PMI index shot up to 54.7pts vs 53.0pts expected, marking thereby new tops in the current cycle. The behavior of Polish PMI is consistent with the evolution of its foreign counterparts (e.g. the current situation assessment of the Ifo index). The comments supplied along with the PMI series suggest the driving force of the index is the inflow of new orders (a leading index). Thereby the chances for so far widely promulgated gloomy outlook for Polish manufacturing are clearly fading and decelerating GDP growth rate in H2 forecasts are far off track. We still expect GDP growth rate in H2 to reach 4.0% y/y; the historical correlation between PMI and GDP (see the graph) constitutes another support for our forecast.



MPC moving sideways

After the abrupt tide of hawkish statements observed at the start of September, the MPC entered the wait-and-see approach. The views among MPC members seem to be roughly balanced (with hawkish Bratkowski calling for 50bp hike on the one side, and dovish Chojna-Duch with the no-hike scenario on the other) and deeply entrenched. In these circumstances it is governor Belka's voice which determines the consensus view and the voting outcome during the meeting.

Governor Belka mentions mainly the gradual expansion of the Polish economy, which turn out to be non-inflationary so far. He does not see any price tensions stemming form the labor market (he somehow trivializes the current pace of wage growth citing record high dynamics of this aggregate in the past). The governor does not expect the fresh projection to show inflation above the MPC target. Although he admits the current level of base rate may be at the low end of the natural rate interval for the Polish economy, the majority of risks (including these for the global economy) speak against monetary tightening at this stage of the business cycle. Among the warning sings (which the MPC is set to carefully monitor) the governor mentions the scenario in which investment accelerates quickly. However, it is far from his baseline view.

We expect inflation to gradually accelerate (see the piece on the forecast of the Ministry of Finance). Complementing this assumption (forecast) with current favorable situation in the enterprise sector (high capacity utilization, substantial level of hoarded cash, lots of foregone investment demand and good perspectives for own production) leaves us with the conclusion, that investment demand is set to accelerate in coming quarters, surrounded by overall GDP growth and mounting demand pressures. There is growing evidence the MPC is not going to rush with monetary tightening and – similar to its predecessors – will be mostly affected by the current inflow of data and react only to clear (realized) inflation trends (not the risks allowing for a pre-emptive strike). The evolution of such a set of information is going to set monetary tightening process in motion in coming months. Meanwhile, the market will be constantly pricing in the risk of monetary tightening.

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	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

Staying in range.

With no important data releases and no other significant events, the FI market fluctuated within a narrow 5bp range. Only Wednesday's auction of the new 2y benchmark bond, OK0113, brought some excitement into this market. Bonds rallied ahead of the auction, 3bio supply attracted quite good demand (bid-to-cover at 2.5), and the Ministry of Finance successfully placed the whole amount.

Recent comments from MPC members didn't clarify the picture much, as they ranged from extremely hawkish Bratkowski, calling for 'unavoidable and immediate need to hike rates" to Chojna-Duch talking about possibility of unchanged monetary policy for the rest of the year. Also Belka's comments were relatively dovish, suggesting wait and see attitude for the time being.

Considering what is currently priced in, the curve (25bp+ hike this year) looks reasonable and therefore it's hard to expect much more pressure in the front end, unless hawkish view receives some solid support from upcoming economic data. Long end of the curve, on the other hand, should remain supported. Asset-swap wise, bond seems quite cheap, fresh supply will be limited in Q4, fiscal situation doesn't seem to be bothering the market for 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	11/10/2010	-	3.918%	27/09/2010
2Y T-bond OK1013	01/12/2010	-	4.595%	06/10/2010
5Y T-bond PS0415	13/10/2010	-	5.431%	06/09/2010
10Y T-bond DS1020	20/10/2010	-	5.456%	15/09/2010
20Y T-bond WS0429	20/10/2010	-	6.170%	15/09/2010

Money Market

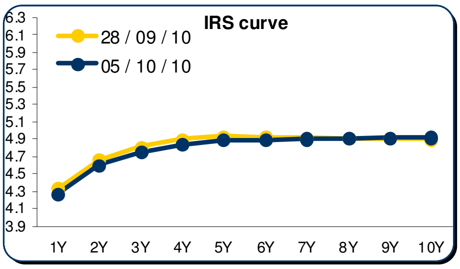
Cheap beginning of the reserve

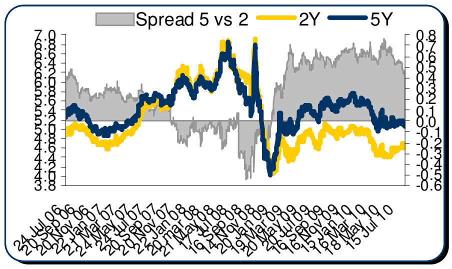
Surprisingly the beginning of the new reserve was relatively cheap with the polonia index nearby the 2.7%. The direct causation was low demand for the money bills that left the system with the PLN 5 billion cash surplus. If tomorrow the scenario repeats itself the cheap October will become a fact.

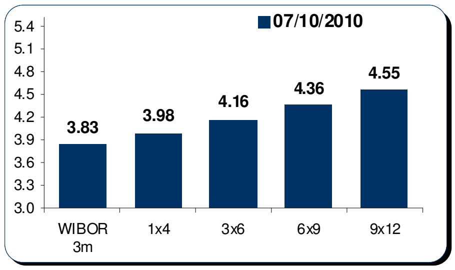
One hike this year still in curve

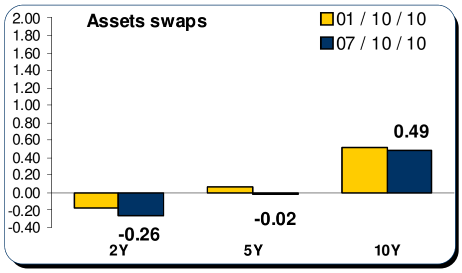
The CPI projection by the MinFin in line with expectations at 2.3%. The market sentiment is quite bullish and the probability layout of the hike is in the straddle between October and November. Nonetheless, one hike this year is still priced in.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in side trend

This week Zloty has started week at 3.96ish level, has traded high at 3.98, then low at 3.9250 just to came back to 3.96ish again. Trading stronger side took place on back of better regional sentiment, while weaker side was caused by Ireland downgrade. Although Zloty has reacted relatively calm (1.5% range) for external shocks (almost 3% EURUSD rally!), weaker USD and weak CNY has already provoked top men talks about “currency wars”. Is Zloty likely to keep this immunity? We have to wait for the answer.

Volatility higher

Aggravated rhetoric which has dominated market talks last days is likely to result with higher volatility on majors. May it translate into same on minor markets? Answer is same as above. Nevertheless we have observed intensive demand for PLN vega and EURPLN vs USDPLN currency spread. New highs for EURPLN ATMs are:1M – 10.75, 3M – 11.75, 1Y - 12.5, currency spread is traded at 7.25. Buyers, however, still have no support form realized vols – last week number is 7.4%, last 3M is only 8.2%.

Short-term forecasts:

SPOT

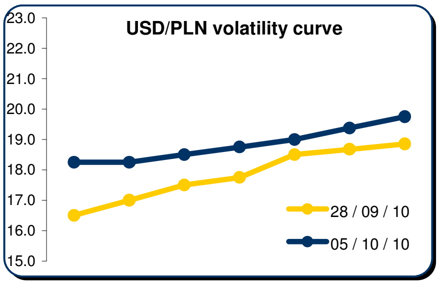
Main supports / resistances:
EUR/PLN: 3.8600 / 4.0500
USD/PLN: 2.8000. / 2.9600

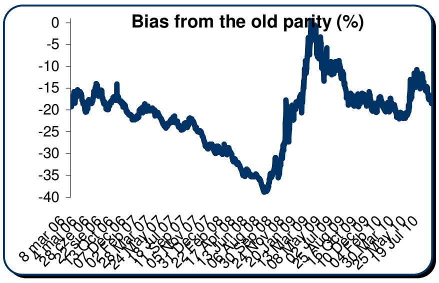
Although so far Zloty stays in tight range, possible rebounds above 4.00 level ma be seen as an exaggeration that will not take long. 4.03 seems so far a good entry level with S/L at 4.07 and P/T at 3.86.

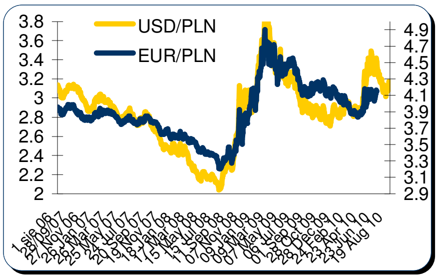
OPTIONS

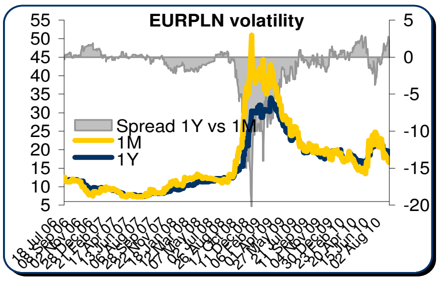
Despite higher implied vols, realized volatility is on our side. We maintain our view the gamma is set to loose on price.

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
01/10/10	3.75%	3.83%	3.63%	3.94%	3.93%	4.16%
04/10/10	3.70%	3.83%	3.95%	3.95%	4.15%	6.59%
05/10/10	3.72%	3.84%	3.90%	6.49%	4.15%	4.16%
06/10/10	3.71%	3.83%	3.94%	3.95%	4.16%	4.15%
07/10/10	3.72%	3.83%	3.93%	3.93%	4.15%	4.15%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
01/10/10	3.97%	4.21%	4.40%	4.60%	4.55%
04/10/10	3.99%	4.14%	4.34%	4.54%	4.52%
05/10/10	3.97%	4.14%	4.34%	4.54%	4.50%
06/10/10	3.98%	4.14%	4.33%	4.53%	4.49%
07/10/10	3.97%	4.14%	4.33%	4.53%	4.50%

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
01/10/10	4.16%	3.93%	4.58%	4.40%	4.86%	4.93%	4.89%	5.41%
04/10/10	6.59%	3.93%	4.61%	4.39%	4.90%	4.91%	4.93%	5.41%
05/10/10	4.16%	3.93%	4.60%	4.34%	4.89%	4.86%	4.92%	5.39%
06/10/10	4.15%	3.92%	4.60%	4.34%	4.88%	4.86%	4.90%	5.39%
07/10/10	4.15%	3.92%	4.60%	4.34%	4.88%	4.86%	4.90%	5.39%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10/09/27	11/09/27	96.189	3.92%	600	1150	580
OK0113	10/10/06	13/01/26	90.178	4.60%	3000	7568	3000
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
01/10/10	17.35	17.85	18.60	18.95	3.25	4.85	0.75	0.90
04/10/10	16.85	17.75	18.45	18.85	3.25	4.85	0.75	0.90
05/10/10	17.10	17.85	18.50	18.95	3.25	4.85	0.75	0.90
06/10/10	17.85	18.25	18.90	19.35	3.50	4.75	0.75	0.90
07/10/10	18.25	18.75	19.00	19.75	3.50	4.75	0.75	0.90

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
01/10/10	2.8772	3.9465	-18.77%
04/10/10	2.8922	3.9577	-18.94%
05/10/10	2.8838	3.9742	-19.45%
06/10/10	2.8422	3.9378	-18.75%
07/10/10	2.8401	3.9655	-19.00%

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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