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FINANCIAL MARKETS DEPARTMENT
PAGES: 8

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of October 15th 2010 to October 21st 2010

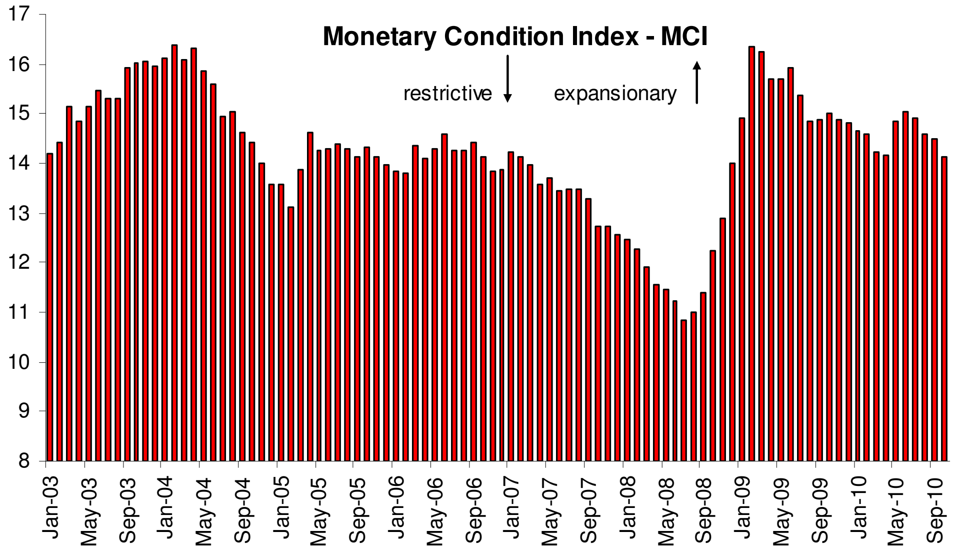
Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Employment y/y	Oct 18	Sep	**1.7%**	1.7%	1.6%	Softer business tendency indicators concerning all sections but internal trade and transports. The pace of hiring softer, in line with expectations regarding future growth of business at the micro level.
Wages y/y	Oct 18	Sep	**2.9%**	4.0%	4.2%	No difference in working days. High growth of wages in manufacturing.
Industrial output y/y	Oct 19	Sep	**10.5%**	10.9%	13.5%	No difference in working days. Higher Ifo and relevant ESI indicators. Growth of industrial output stabilizes at a high level.
Producer prices y/y	Oct 19	Sep	**4.1%**	4.4%	3.9%	Price expectations slowly on the rise (marking new highs since the end of 2008). Stable EURPLN rate, higher prices of copper and gold.

In Focus / Macroeconomics

Inflation on the rise

September's CPI Inflation surprised to the upside and topped 2.5% y/y (MF forecast 2.3%, market consensus 2.3%, our call 2.4-2.5%). The surge in inflation (the actual monthly growth, at 0.6%, was twice the expected rate) can be attributed mainly to food prices which accelerated to 2.0% on monthly basis, similar to the developments observed in 2007. Despite acceleration in some core categories (education, clothing), core inflation may have stayed at 1.2% (much would depend on rounding so we would rather quote 1.1-1.2% interval). As the history likes to repeat itself, the acceleration of food prices is likely to follow the pattern sketched in 2007 (with minor downward revision owing to the strength of the shocks responsible for the surge in food prices this time) and pull CPI towards 2.7-2.8% in October and over 3.0% at the end of the year.

The start of 2011 will be marked by a series of state-controlled and regulated price hikes (this is usual effect, but this time it may be stronger as local governments are seeking ways to balance their budgets and successfully dispose of EU funds) and VAT hikes (the so far estimated, cumulated response of CPI to the shock of this origin is placed within 0.4-0.7% interval). In our opinion, 2011 will be marked with pure inflationary pressures stemming from the growth of the economy. Although we do not have precise calculations (too short time series to engage in any meaningful calculations), it is possible that due to a halt in private investment process, potential GDP is now running below the levels recorded earlier.



The MPC seems to be (at least to some extent) well aware of the factors connected with food prices and VAT hikes. However, it seems there is no consensus at the moment the Polish economy is able to generate inflationary pressures at this stage of recovery. Moreover, mind that the most hawkish members of the Committee (calling for 50bp. hike) are concentrating on the stabilization of inflation expectations According to the latest surveys, there is nothing to stabilize…Should expectations surge again (the data will be promulgated just before the decision), the MPC is going to think twice before it exploits this channel, as once it proved very misleading. Hence, there will be a need of confirmation of a change in trend in this (important) driver of CPI, speaking against a hike already in October.

The tailwind for less hawkish members of the Committee blows also from low core inflation (although we think it will accelerate sharply in 2011, we are not sure whether this is supported by the majority at the moment – MPC seems data dependent, thus we do note expect any action before core inflation is on the rise) and perspective of stable employment (we think enterprises have already hired in anticipation of current better data and forecast, now they may need a time to think which would look like stagnation from third parties perspective). Last but not least, recent zloty appreciation (and break below technically important levels which may herald further

downward movement) adds to the restrictiveness of the monetary policy (see the graph on MCI). Moreover, small hike (**after the correction of inflation expectations, 50bp. seems out of question**) will generate expectations on further adjustment, giving additional boost for the zloty (the coincidence with the publication of inflation projection may make impression, the rate adjustment is indeed forward-looking and hence, the start of the series of hikes). Given the overwhelming fears within MPC on the fragile state of the Polish economy (especially in volatile global environment), further strengthening of the zloty (as a blunt side-effect of monetary policy) may be hardly accepted.
We do not argue that MPC will refrain from hiking rates this year. Rather, we are trying to present all the MPC dilemmas and why it may decide to wait a bit to see more convincing data. Going forward, ss inflation expectations are unlikely to stay benign in an environment of rising food prices (they did not in 2007, why should they now?), it will slowly become a reasonable argument for a tightening of monetary policy (although it is important to see a trend in here, not simply a spike – that is why October's behavior of this measure may be irrelevant). It is also possible we have reached a bottom in core inflation (again, the trend is important) and the CPI inflation will embark on an upward trip (it is possible to imagine that rising inflation is something different for the even most dovish MPC members when it surpasses the 2.5% target). **Also the inflow of data from the real sphere (industrial output, retail sales) is set to support current FRA rates. We expect one hike till the end of the year and would rather bet now on a start of the tightening cycle, not the *correction* of rates (we think the potential of such a call have recently burnt out).**

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

CPI pushing rates higher. Sell-off getting overdone.

We could easily skip the last week market analysis till Wednesday 13th. Although there was some paying interest in 5Y10Y moving up the curve to the more positive areas (around +5 points comparing to even -2 downside), the market stayed calm awaiting the new 5Y issue of treasury bonds and CPI release for September.

On Wednesday 13th the Ministry Of Finance managed to sell only 2.5 billion zlotys of a new 5% PS0416 5Y benchmark with a demand of 3.4 billion only. The quite not satisfactory demand triggered some sell-off on domestic bonds and pushed up the yield curve around 3-4bp. Most impact on the market however came from CPI data, which were released at 2.5% y/y, two ticks above market expectations. That cause even more pressure especially in the front end of the curve - overall 2y IRS moved up to 4.70%, 10bp above this week's low. Selling on bonds also continued, the PS0416 traded 25 ticks below auction's minimum.

Comment's from MPC members were quite mixed, Bratkowski reiterated about the immediate necessity of a rate hike, on the other hand, Kazmierczak and Chojna-Duch didn't see the inflation data as an important event from policy's perspective.

Generally we think market reaction was a bit too sharp. 50bp tightening this year, already priced in the curve doesn't really leave room for short rates to climb up further, especially that next economic releases are not likely to further support hikes strongly. Longer maturities start to look relatively cheap in asset-swap terms, especially October bonds, which cheapened artificially due to coupon payment. It looks to us, that rates are in a range and at current levels we're close to the upper band, therefore we see good chances for a move down in the upcoming week.

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	10/18/2010	-	3.918%	9/27/2010
2Y T-bond OK1013	12/1/2010	-	4.595%	10/6/2010
5Y T-bond PS0416	12/1/2010	-	5.137%	10/13/2010
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

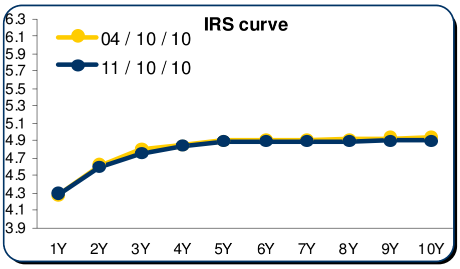
Oversubscribed huge OMO

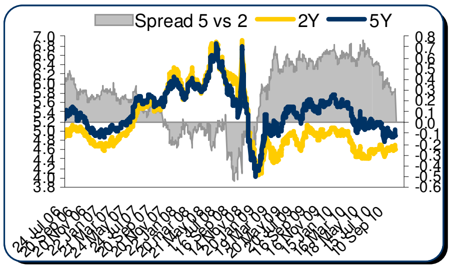
Cost of carry higher than in previous week due to oversubscribed OMO, which itself if matched was leaving the system short for about PLN 2.5 billion. This will probably implicate lower demand during tomorrow's auction and carry again below 3%.

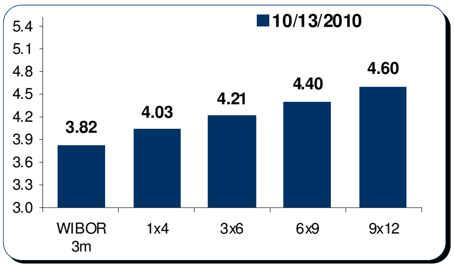
CPI accelerates

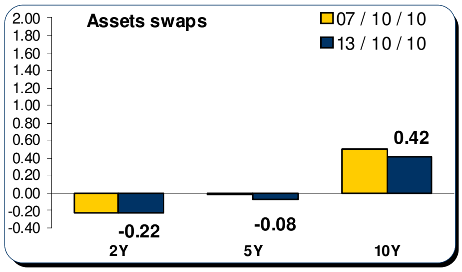
Bearish sentiment is back after yesterday's release of the CPI data. The market was expecting 2.3% and the real data was 2.5%. The only factor that keeps bulls alive right now is strong currency. We are not original in our forecast for the next MPC, giving probability for the hike at 50%...

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Since early September EURPLN has been trading in 3.92/3.99 range. Finally, on Wednesday afternoon, Zloty has broke out of this range (briefly touching 3.89 low.) Story behind? Market has been caught on short PLN positions by privatization inflow and stronger EUR (1.40 broken), higher CPI in Poland . Nevertheless, despite strong move we estimate number of PLN interests as low and forming of new range is very likely, simply shifted to the south 3.85/3.95 (?).

Recent vol demand is a distant past. Reasons which caused 3M EURPLN ATM being paid at 11.75 faded and now same tenor is traded at 11.0. Long end has stayed almost untouched – 1Y range 12.0-12.25. Short end is traded actively between 10.0-10.6 where higher value is supported by underlying performance (weekly realized volatility about 10.3%). Lower spot levels affected also RR run where 3M 25D benchmark is traded at 2.5 (3.0 at beginning of week).

Volatility lower

As against to lower EURPLN run, USDPLN vs. EURPLN currency spread is still traded at recent high 7.25% level.

Short-term forecasts:

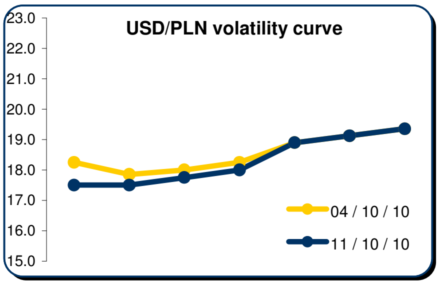
SPOT

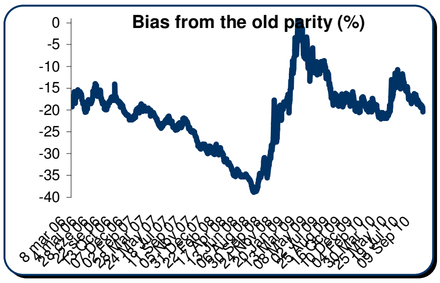
Main supports / resistances:
EUR/PLN: 3.8600 / 4.0500
USD/PLN: 2.7000 / 2.8700

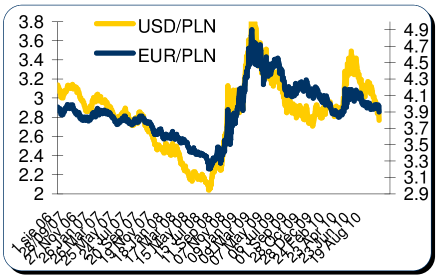
We are still Zloty positive. Due to the possible downward shift of the range (3.85-3.95) we lowered the desired entry level to 3.96, S/L at 3.99, and T/P at 3.8500.

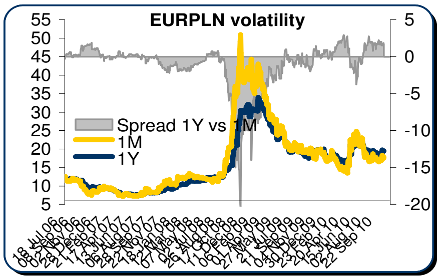
OPTIONS
Braking out of range may result with period of elevated volatility. Falling gamma has then become less probable at the moment and we are now neutral in here (until the situation evolves in a new, or old, way). Settling new EURPLN range and possible further strengthening may result by longer end lower vols. We expect lower vega and one may try to follow this possibility by low delta puts.

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
07/10/10	3.72%	3.83%	3.93%	3.93%	4.15%	4.15%
08/10/10	3.73%	3.83%	3.92%	3.94%	4.16%	6.59%
11/10/10	3.70%	3.82%	3.96%	6.49%	4.14%	4.15%
12/10/10	3.70%	3.82%	3.91%	3.94%	4.16%	4.15%
13/10/10	3.72%	3.82%	3.90%	3.93%	4.15%	4.15%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
07/10/10	3.97%	4.14%	4.33%	4.53%	4.50%
08/10/10	3.97%	4.15%	4.34%	4.54%	4.51%
11/10/10	3.98%	4.16%	4.35%	4.55%	4.51%
12/10/10	3.98%	4.16%	4.36%	4.55%	4.50%
13/10/10	3.99%	4.15%	4.34%	4.54%	4.51%

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
07/10/10	4.15%	3.95%	4.60%	4.38%	4.88%	4.86%	4.90%	5.40%
08/10/10	6.59%	3.95%	4.59%	4.38%	4.89%	4.86%	4.90%	5.40%
11/10/10	4.15%	3.93%	4.59%	4.36%	4.89%	4.86%	4.90%	5.39%
12/10/10	4.15%	3.92%	4.60%	4.36%	4.91%	4.86%	4.97%	5.41%
13/10/10	4.15%	3.99%	4.71%	4.49%	5.01%	4.93%	5.02%	5.44%

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
PS0416	10/10/13	16/04/25	99.300	5.14%	3000	3414	2491
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
07/10/10	18.25	18.75	19.00	19.75	3.50	4.75	0.75	0.90
08/10/10	18.00	18.50	18.90	19.50	3.50	4.75	0.75	0.90
11/10/10	18.00	18.25	18.90	19.50	3.50	4.75	0.75	0.90
12/10/10	18.00	18.25	18.90	19.50	3.50	4.75	0.75	0.90
13/10/10	17.50	18.00	18.90	19.35	3.25	4.50	0.75	0.90

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
07/10/10	2.8401	3.9655	-19.00%
08/10/10	2.8660	3.9860	-19.51%
11/10/10	2.8525	3.9754	-19.03%
12/10/10	2.8802	3.9711	-19.59%
13/10/10	2.8327	3.9587	-19.37%

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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