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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of October 22nd 2010 to October 28th 2010

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Retail sales	Oct 26	Sep	**7.0%**	6.6%	6.6%	A minor base effect (towards lower reading) more than offset by home appliances (very positive business activity assessment) and a surge in auto sales.
MPC decision	Oct 27	-	**3.50%**	3.50%	3.50%	MPC in a wait-and-see mode. Taking into account the supply nature of CPI rise (food prices) and the reluctance of the whole body to admit a serious risk to demand-driven inflation, inflation expectations are the key. However, given the nature of expectations (adaptive with a mean 2 period lag), the MPC is not going to see anything threatening this month. The same applies to inflation projection.

In Focus / Macroeconomics

Polish real sphere in solid upward trend

Last week brought some confirmation to the picture of the real sphere of the economy. We got additional (positive) insight into the labor market and were assured the trends observed in manufacturing were left intact. Although the data seem to confirm the ability of Polish economy to generate inflationary pressures in the near future, it is neutral for the upcoming MPC decision as it does not change the current status quo.

Labor market. September's employment surprised to the upside, reaching 1.8% on annual basis (market consensus 1.7%). On monthly basis it translates into a rise in employment by 15k, erasing thereby a less positive message delivered by the near-zero monthly growth in August.

Although it is too soon the get too excited about one figure (possibly seasonally distorted), the data clearly contradicts the reading of business activity indicators (pointing to a slow moderation of hiring activity). Such a constellation demands caution, however, there is no reason not to be bullish on the Polish labor market. Taking a close look at a data of lower frequency suggests that once the hiring process starts, there are no backward steps, moderation at best. As employment is slowly approaching pre-crisis levels (mind the difference in jobless rate, in favor of the current situation), there is only a quick step to a situation in which the bargaining power of employees rises enough to build wage pressures. Although last reading of wages was commonly thought as low (+3.7% y/y) one should bear in mind two facts: 1) distorting influence of the data on mining, 2) solid trend in the growth rate of wages in manufacturing (yet 5-6%). That is why such a divergence from consensus (4.0%) can be regarded as nothing more than a confirmation of recent, upward (and sustainable) trend in wages. Briefly speaking, the labor market may be evolving according to what now seems to be the minority scenario among MPC members.

Industrial output. September saw industrial production rising by 11.8% y/y. A drop in annual growth is mainly attributable to working days effect. Seasonally adjusted figure was pretty close to August reading and amounted to 12.1% y/y. Upside surprise stems mainly from a huge bounce in auto vehicles production.

As It was the case last month, the recovery is broad based (28 out of 34 sections recorded positive annual output dynamics) and continuously stimulated by exports (mainly to Germany). Positive data flow from Germany (rising new orders) indicate that this tendency may be supported well into 2011.

High industrial output figures already suggest the GDP could grow by 4% y/y in Q3 2011. Our forecast is also supported by rising construction output (13.4% y/y in September) and some anecdotal evidence that after a summer lull the infrastructure projects jump-started, pushing investment dynamics higher.

Implications. Complementary to the real data was the release of producer prices, which accelerated to 4.3% on annual basis. The data point clearly that potential inflationary pressures are mounting (as are inflation expectations formulated by enterprises). Tightening of the labor market can only add to the ongoing tendency once wage expectations are unleashed. The latest discussion among MPC members suggests that the hawkish minority is fully aware of this risk (pointing that previous low investment may mean the output gap will close more quickly generating inflationary pressures). It was articulated by the 50bps hike motion submitted (but turned down) at the meeting. We think it is possible for that motion to survive also to the upcoming meeting. However, neither inflation projection, neither the inflow of the data on inflation expectations (due to their adaptive nature, we do not expect any spike – similar to August one) will be convincing enough for the current majority within MPC (including governor). However, the behavior of inflation (and inflation expectations) and the solid inflow of the real sphere data is going to persuade the "hesitants" the monetary tightening is not only looming but there is a need to act immediately. We put our 25bps call on November.

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

Significant repricing. Tightening cycle on the table?

Last week we saw rates climbing higher yet again. In our opinion there were two main drivers. First one was sell off in Bunds, and second one was the coupon washing on the October bonds. DS1020 traded as low as 97.30, 120 cent lower within 2 weeks, 2y traded up at 4,80 as we saw some stop losses going through, especially driven by international banks. While turnover on the bonds was rather modest, the flow in the IRS market was pretty impressive. Curve was steepening especially in the 2y5y area. The next big event to watch will be RPP meeting. Minutes after September meeting gave very little inside. 50bp motion was dropped, and the comment really lacks details, which points for another toss of a coin bet for October meeting. Our view remains unchanged. We prefer to play economic data, rather than decision itself. We think that sell off in the October bonds went a little to far, and it is maybe a good technical point to reenter long position in 10y bonds. We also think that 3x6 PLN FRA is the most expensive contract on the curve. The preemptive move in our opinion is getting less and less probable, we may rather see normal tightening cycle, therefore we see value in paying FRA spreads, or selling 3x6 PLN FRA at current valuations.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6,142%	08-12-09
26 Week T-bills	-	-	4,456%	09-05-04
52 Week T-bills	10-10-25	-	3,918%	10-09-18
2Y T-bond OK1013	10-12-01	-	4,595%	10-10-06
5Y T-bond PS0416	10-12-03	-	5,137%	10-10-13
10Y T-bond DS1020	10-11-17	-	5,456%	10-09-15
20Y T-bond WS0429	-	-	6,170%	10-09-15

Money Market

High probability of cheap week

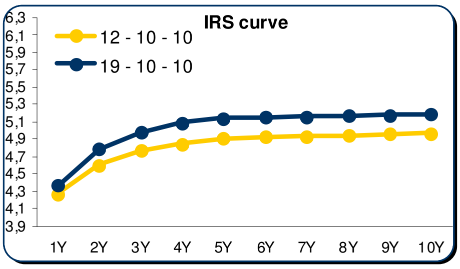
Global factors more important then local figures

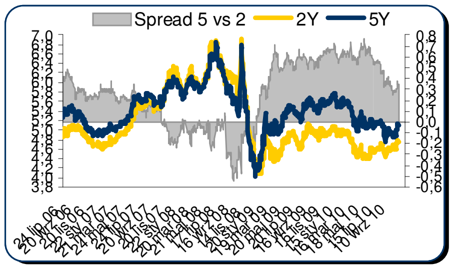
Just as we were forecasting the cost of carry last week was just below 3%. Tomorrow's OMO will determine the carry during the last reserve settlement week. We see the probability highly asymmetric towards the falling shortest rates with the level on next Friday's closing nearby the deposit rate.

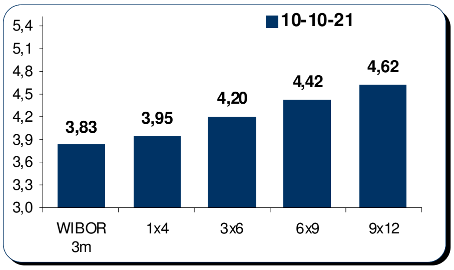
Wages, PPI, and industrial output figures without any significant influence on the curve, which now is mainly driven by global and currency factors. The MPC minutes also inconclusive with the 50 bps again being voted, however without majority. This is 2nd month of this scenario, therefore we do not put too much weight to its potential success during the next meeting.

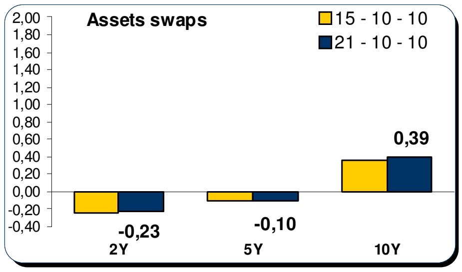
T-bills still around 4% during the auction (precisely average yield at 3.97%) and on next Monday the level will be very similar.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

Short are periods of PLN's strength…After breaking in previous week 3.92 support (3.89 low) since Monday we have faced continues sell off of PLN longs. In two trading days Zloty has lost 2% setting Low/High at 3.9000/3.9750. Signal as always has came from abroad: weaker EUR and a vague condition of US mortgages. Since creating a stable sentiment seems improbable, most likely is scenario where Zloty will be trading in volatile range.

Volatility untouched

Implied volatility curve has not reflected neither stronger nor weaker Zloty. Simply supported by realized volatility (weekly realized about 10%) has retained former shape: 1M 11.0, 3M 11.25, 1Y 12.35. Tiny adjustment has took place on smile where 3M 25D RR has been trading bit lower at 2.3%. USDPLN vs. EURPLN currency spread, supported by volatile EURUSD market, keeps, well bid, 7.25 level.

SPOT

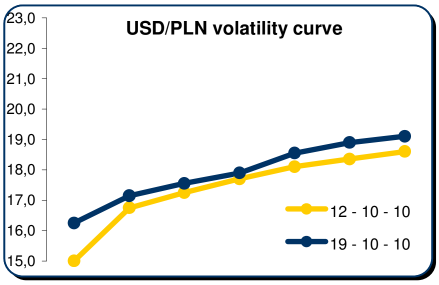
Short-term forecasts:

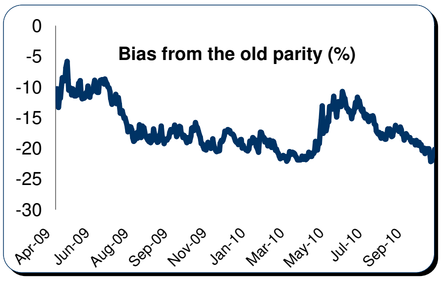
Main supports / resistances:
EUR/PLN: 3.8600 / 4.0500
USD/PLN: 2.7000. / 2.8700

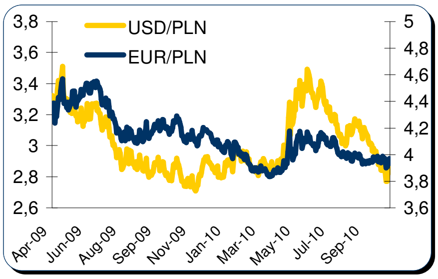
Although sentiment unwind looks bit spectacular we remain positive on Zloty. Keep EURPLN short opened at 3.96, leave S/L at 3.99 and move P/T to 3.90.

OPTIONS
"Breaking out of range may result with period of elevated volatility. We have closed our short gamma then and will wait to reenter it". That's what we have written in our previous report. Even with "elevated periods", realized volatility simply reaches implied one – EUR/PLN gamma is set to fall then. Another idea (hedge) relies on a gaining USDPLN gamma. Driven by EURUSD volatility and negative correlation is likely to exceed realized one (last week 25% against to 18% of implied!).

FX CHARTS


USD/PLN volatility curve
23,0
22,0
21,0
20,0
19,0
18,0
17,0
16,0
15,0
12 - 10 - 10
19 - 10 - 10


Bias from the old parity (%)
0
-5
-10
-15
-20
-25
-30
Apr-09
Jun-09
Aug-09
Sep-09
Nov-09
Jan-10
Mar-10
May-10
Jul-10
Sep-10


USD/PLN
EUR/PLN
3,8
3,6
3,4
3,2
3
2,8
2,6
5
4,8
4,6
4,4
4,2
4
3,8
3,6
Apr-09
Jun-09
Aug-09
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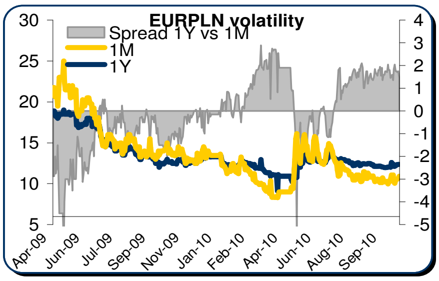
Mar-10
May-10
Jul-10
Sep-10


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
30
25
20
15
10
5
4
3
2
1
0
-1
-2
-3
-4
-5
Apr-09
Jun-09
Jul-09
Sep-09
Nov-09
Jan-10
Feb-10
Apr-10
Jun-10
Aug-10
Sep-10

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
15-10-10	3,70%	3,82%	3,92%	3,93%	4,16%	4,16%
16-10-10	3,70%	3,82%	3,90%	3,94%	4,15%	6,59%
19-10-10	3,75%	3,82%	3,92%	6,49%	4,15%	4,16%
20-10-10	3,75%	3,83%	4,00%	3,94%	4,21%	4,16%
21-10-10	3,75%	3,83%	3,93%	3,94%	4,17%	4,16%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
15-10-10	3,98%	4,15%	4,34%	4,54%	4,51%
16-10-10	4,03%	4,21%	4,40%	4,60%	4,60%
19-10-10	4,02%	4,21%	4,41%	4,61%	4,58%
20-10-10	4,05%	4,24%	4,44%	4,63%	4,59%
21-10-10	4,01%	4,22%	4,44%	4,65%	4,60%

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
15-10-10	4,16%	4,04%	4,75%	4,50%	5,09%	4,98%	5,13%	5,49%
16-10-10	6,59%	4,04%	4,75%	4,50%	5,09%	4,98%	5,13%	5,49%
19-10-10	4,16%	4,04%	4,79%	4,50%	5,14%	5,04%	5,19%	5,56%
20-10-10	4,16%	4,04%	4,78%	4,50%	5,13%	5,03%	5,15%	5,54%
21-10-10	4,16%	4,03%	4,75%	4,52%	5,09%	4,99%	5,13%	5,52%

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
15-10-10	17,30	17,75	18,55	19,05	2,30	4,05	0,45	0,72
16-10-10	17,30	17,75	18,55	19,05	2,30	4,05	0,45	0,72
19-10-10	17,15	17,90	18,55	19,10	2,30	4,20	0,15	0,37
20-10-10	17,50	18,05	18,60	19,10	2,40	4,20	0,15	0,37
21-10-10	17,60	18,05	18,60	19,10	2,40	4,20	0,15	0,37

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
15-10-10	2,7717	3,9074	-22,1%
16-10-10	2,7717	3,9074	-22,1%
19-10-10	2,8268	3,9317	-21,1%
20-10-10	2,8714	3,9700	-20,2%
21-10-10	2,8714	3,9700	-20,2%

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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