



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of October 29th 2010 to November 4th 2010

Indicator	Date of release	Pe-riod	BRE forecast	Consensus	Last	Comment
FinMin's inflation forecast	Nov 2	Oct	2.8%	-	2.5%	The hump-shaped impulse-response generated upon food prices path is slowly fading, although it is still sufficient to lift monthly growth rate considerably above seasonal pattern. Adding a turnaround in fuel prices and gas price hike we arrive at 2.8% y/y in the headline and 1.2% in the core inflation.
PMI	Nov 2	Oct	53.6pts	-	54.7pts	Business activity off the last month's level. Plus a high probability of a lower order correction (usual feature of this series after a two months of solid growth) from last month's peak.

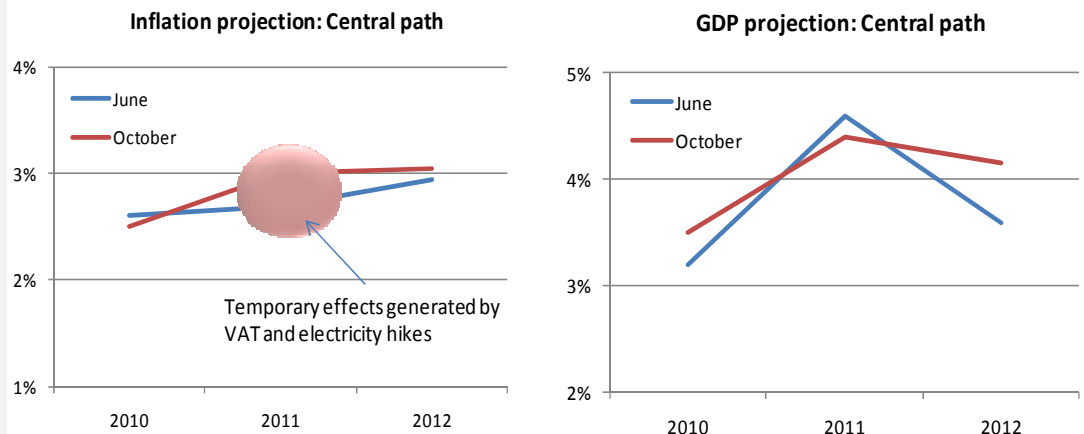
In Focus / Macroeconomics

NBP rates on hold. Dovish statement.

In line with our expectations, NBP rates were left on hold. The only change the MPC decided on was a hike in reserve requirement ratio (+0.5pts, now 3.50%) from December 31. On the one hand, higher reserve requirement ratio may be some sort of a tacit agreement between the governor and the hawks. On the other it may prelude the normalization of monetary policy (as Belka wryly replied at the conference) but the impact on systemic over-liquidity can be described as no more than minimal as it will drain about PLN 4bn (from the already existing 80bn pool).

Turning to the statement, it seems more dovish than it used to be in the last two months. Among the factors influencing this more dovish course are i) fears about the flattening of the global growth rate (accompanied by the list of uncertainties regarding mainly the effects of a combination of a more restrictive fiscal policy and non-standard expansive monetary policy), ii) no definite signs of mounting inflationary pressures (inflation projection is flat in 2012 and higher, food-driven inflation now does not influence inflation expectations). Moreover, the part of the statement in which MPC usually communicates the reasoning behind the decision contains an explicit reference to a process of global recirculation of capital towards emerging markets in an environment of "easy money". We think then the MPC is overly concentrated (and very sensitive to) changes in PLN exchange rate. Such a view is backed by the comments given by the vice-governor Kozinski who explicitly claims the hike would translate into stronger PLN, whereas NBP is content with the current valuation of the Polish zloty. Wrapping up, the "global" line of reasoning which can be felt in the whole statement indicates that governor Belka's influence over the decision process is gaining on importance.

As for the projection itself, we present central paths on the graphs below. We only remind the reader that the central path of inflation at the long end (2012) is only 0.1pp. higher than presented in June's NBP attempt. The only change is a considerable "belly" visible in 2011, a product of one-off factors. Again, given the boost of inflation in 2011 and the propagation mechanism in the NECMOD model +0.1pp. in 2012 looks like inflationary pressures in the economy (and inflation expectations) leave a lot of space to maneuver for the MPC right now.



We think that the upcoming MPC decision will be to a great extent a reflection of Belka's global reasoning. That is why we think the probability of a hike is much lower than 100% implied by the OIS contracts. Actually, we would rather bet on early 2011 as a mark of a start of the tightening cycle. In the meantime, the inflow of current data (mainly inflation) would not let rate hike expectations to evaporate.

The longer the MPC waits with a prompt reaction, the bigger is the probability that the cumulative tightening will be closer to the previous ones.

**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	3.5↓	4.50

Indicator	2009		2010			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	1.7	3.1	3.0	3.5	3.9	4.0
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	3.5↓

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

Fixed Income

No hikes this year

Rates moved higher again in the beginning of the week, before Wednesday's MPC decision. Very front end of the curve suffered the most, with 3x6 trading at 4.25% and 9x12 at 4.78%. Rates however were left unchanged again, except from raising reserve requirement ratio from 3.00 to 3.50%, which cannot really have any significant impact on the market, as it will result in reducing over liquidity by some 4bio from current 80bio. Statement after the decision sounded quite dovish, pointing to low core CPI and still low inflation expectations. New inflation projection also supports Council's view. No hike and soft comments resulted in significant pullback of the front end (FRAs and 2Y moved down by some 10-12bp) and some steepening in 2Y-5Y and 5Y-10Y spreads. From current perspective it's hard to expect serious signals of hawkishness in the near future. Next CPI readings are likely to be higher, but that is already expected by MPC, other data this month won't probably show any potentially strong inflationary pressure. All that makes tightening this year unlikely. In the front end we still see potential of FRA spread widening (3x6 ag 6x9 or 9x12).

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	11/22/2010	-	4.056%	10/25/2010
2Y T-bond OK1013	12/1/2010	-	4.595%	10/6/2010
5Y T-bond PS0416	12/3/2010	-	5.137%	10/13/2010
10Y T-bond DS1020	11/17/2010	-	5.456%	9/15/2010
20Y T-bond WS0429	-	-	6.170%	9/15/2010

Money Market

Expensive carry this week

Reserve rate 50 bps up starting on 31st December

T-bills yields up during the auction

Relatively high cost of carry this week as the result of the demand covering PLN 82 billion during the OMO last Friday. All papers were bought, despite the fact that liquidity forecast for the system was showing the shortage. The reserve is therefore under-built and tomorrow's auction is the last resort to square the requirements. If not, we will face the squeeze not seen for a long time.

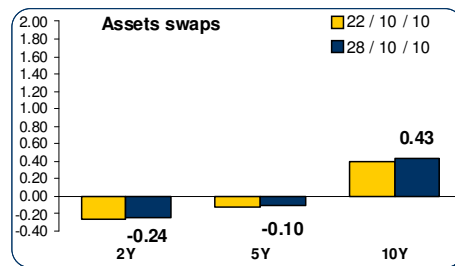
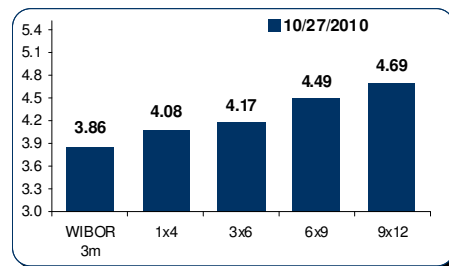
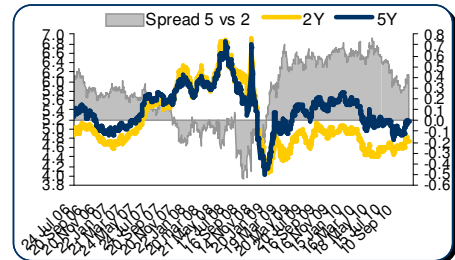
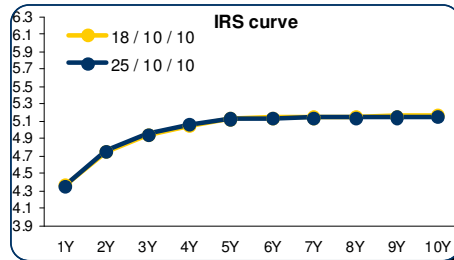
The MPC did not change the market rates, however they increased the obligatory reserve rate by 50 bps. The change is valid starting 31 December, which will allow banks to adjust their deposit rates ex ante (3M average is taken to estimate the requirements), at least partially. For the system liquidity this hike means nothing since in the nominal value it is less than PLN 4 billion, comparing to the current over-liquidity, which measured by the on the run money bills is around PLN 80 billion.

Right now there is 25 bps hike expected in November and built into the MM curve, and 75 bps expected in the whole cycle (Ois curve). We give the probability for this scenario below 50%,

FIXED INCOME & MONEY MARKET CHARTS

especially for the November hike. They might be waiting for the next CPI projection which is February. The argument may be in their comment that hiking the reserve rate is a kind of the tightening already. Moreover, the currency is strong and they give much weight to this factor (probability of staying strong is very high).

T-bills average yield up during the last auction. 4.056 level against 3.97 previously.



Foreign Exchange

Zloty in range

At the beginning of the week, Zloty moved into the stronger territory on back of interest rates hike expectations and the EUR/USD rally. After "no change" Wednesday announcement from the MPC, EUR/PLN reversed its trend and briefly touched the 3,9760 high. The bigger picture is unchanged. Polish Zloty has preserved, the well defined 3,9000-4,0000 range.

Short gamma in demand

The short term options with expiries just after the FED announcement (i.e. 4th of November strike 3,95) were in great demand. This demand has managed to move higher the front end of the EUR/PLN volatility curve. But as the implied curve is well above the realized values the move was not so big (roughly 2% on 1 week, 0.25% on 3month, and no change on 1year).

SPOT

Short-term forecasts:

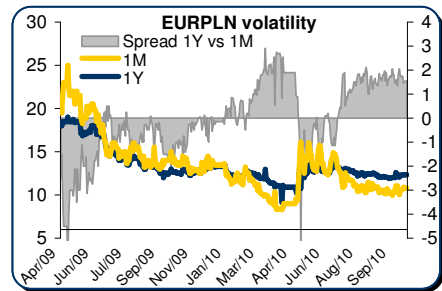
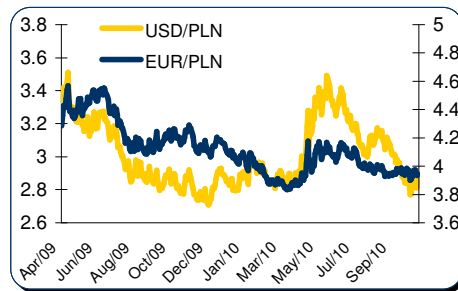
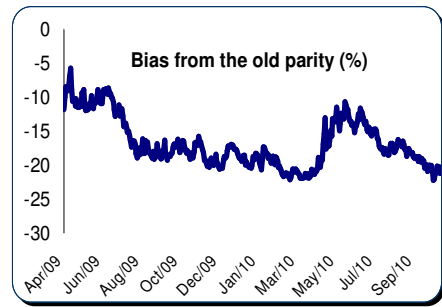
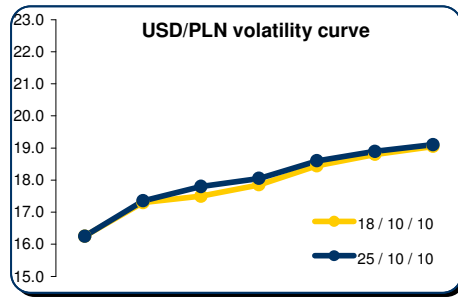
Main supports / resistances:
 EUR/PLN: 3.9200 / 3.9800
 USD/PLN: 2.7900. / 2.9000

We are generally Zloty bulls due to positive macro story but it seems the Zloty is boxed in the range. Due to the range, selling EUR/PLN at the 3.9750/3.9850 level with S/L above 4,000 and P/T at 3.9200 seems a good idea. Eventually, again due to the range, one may consider a small tactical long from 3.9200 (with a short S/L) for a move up, into the middle of the range.

OPTIONS

Short gamma is still in demand and we would like to stick to the previously formed idea. On the other hand we would remind the behavior of USD/PLN gamma may be different (neutral price action or even possibility of a rise) as we think it will be the USD/PLN cross that would take most of the effect of the FED announcement regards the QE2.

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
21/10/10	3.75%	3.83%	3.93%	3.94%	4.17%	4.16%
22/10/10	3.71%	3.83%	3.95%	3.95%	4.15%	6.59%
25/10/10	3.74%	3.84%	3.95%	6.49%	4.16%	4.17%
26/10/10	3.74%	3.86%	3.94%	3.95%	4.18%	4.17%
27/10/10	3.70%	3.86%	3.94%	3.95%	4.18%	4.17%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
21/10/10	4.01%	4.22%	4.44%	4.65%	4.60%
22/10/10	4.00%	4.24%	4.49%	4.69%	4.64%
25/10/10	3.99%	4.24%	4.48%	4.68%	4.63%
26/10/10	3.95%	4.20%	4.42%	4.62%	4.58%
27/10/10	3.95%	4.19%	4.46%	4.65%	4.63%

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
21/10/10	4.16%	4.03%	4.75%	4.52%	5.09%	4.99%	5.13%	5.52%
22/10/10	6.59%	4.01%	4.75%	4.49%	5.11%	4.99%	5.14%	5.54%
25/10/10	4.17%	4.01%	4.76%	4.49%	5.13%	4.98%	5.15%	5.54%
26/10/10	4.17%	4.01%	4.82%	4.52%	5.19%	5.04%	5.22%	5.60%
27/10/10	4.17%	4.02%	4.75%	4.49%	5.18%	5.05%	5.22%	5.63%

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

date	USD/PLN 0-delta straddle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
21/10/10	17.60	18.05	18.60	19.10	2.40	4.20	0.15	0.37
22/10/10	17.55	18.10	18.65	19.10	2.40	4.20	0.15	0.37
25/10/10	17.35	18.05	18.60	19.10	2.40	4.20	0.15	0.37
26/10/10	17.40	18.05	18.60	19.10	2.45	4.20	0.15	0.37
27/10/10	17.45	18.05	18.60	19.10	2.50	4.20	0.15	0.37

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
21/10/10	2.8193	3.9533	-21.0%
22/10/10	2.8616	3.9734	-20.3%
25/10/10	2.8119	3.9464	-21.1%
26/10/10	2.8207	3.9351	-21.2%
27/10/10	2.8567	3.9446	-20.7%

Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50
Mid-market volatility of vanilla option strategies

Contact Details

BRE BANK SA

Ul. Senatorska
18
00-950 Warszawa
P.O. Box 728
Poland

Reuters Pages:
BREX, BREY,
and BRET

Bloomberg: BRE

SWIFT:
BREXPLPW

www.brebank.pl

Forex (BREX) - FX Spot & Options

Marcin Turkiewicz (+48 22 829 01 84) marcin.turkiewicz@brebank.pl
Jakub Wiraszka (+48 22 829 01 73) jakub.wiraszka@brebank.pl
Tomasz Chmielarski (+48 22 829 01 78) tomasz.chmielarski@brebank.pl

Fixed Income (BREP) - FRA, IRS, T-Bonds, T-Bills

Lukasz Barwicki (+48 22 829 01 93) lukasz.barwicki@brebank.pl
Paweł Białczyński (+48 22 829 01 86) pawel.bialczynski@brebank.pl

MM (BREP) - MM

Bartłomiej Małocha, CFA (+48 22 829 01 77) bartlomiej.malocha@brebank.pl
Bogumił Modzelewski bogumil.modzelewski@brebank.pl

Structured Products (BREX)

Jarosław Stolarczyk (+48 22 829 01 67) jaroslaw.stolarczyk@brebank.pl
Jacek Dereziński (+48 22 829 01 69) jacek.derezinski@brebank.pl

Institutional Sales (BRES)

Inga Gaszkowska-Gębska (+48 22 829 12 05) inga.gaszkowska-gebska@brebank.pl

Research

Ernest Pytlarczyk, PhD, CFA (+48 22 829 01 66) ernest.pytlarczyk@brebank.pl
Marcin Mazurek (+48 22 829 0183) marcin.mazurek@brebank.pl

Financial Markets Department

Phone (+48 22 829 02 03)
Fax (+48 22 829 02 45)

Treasury Department

Phone (+48 22 829 02 02)
Fax (+48 22 829 02 01)

Financial Institutions Department

Phone (+48 22 829 01 20)
Fax (+48 22 829 01 21)

Back Office

Phone (+48 22 829 04 02)
Fax (+48 22 829 04 03)

Custody Services

Phone (+48 22 829 13 50)
Fax

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