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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of November 5th 2010 to November 11th 2010

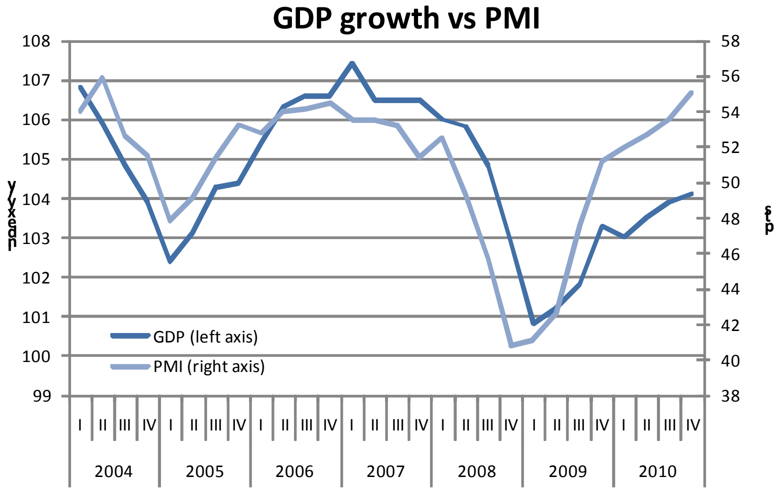
Indicator	Date of release	Pe-riod	BRE forecast	Consen-sus	Last	Comment
C/A balance	Nov 10	Sep	**-1417mln**	-1180mln	-1129mln	Solid growth of industrial output (slightly softer than in 2008-2009). Negative EU transfers account. Income account reverting to "normal", more negative level.
M3 Supply y/y	Nov 10	Oct	**7.2%**	6.8%	8.9%	High statistical base from 2009. PGE floating raised the deposits of financial institutions by PLN 13bn in October.
CPI Inflation	Nov 15	Oct	**2.8%**	2.8%	2.5%	Although the Ministry of Finance sticks to 2.9% growth of CPI, we think that food prices may be slightly overestimated (+1.4% - we would rather bet on +1.0%). Core inflation stays at 1.2%.
Wages y/y	Nob 18	Oct	**3.3%**	3.8%	3.7%	Working day's effect. Manufacturing running still at 5-6%.
Employment y/y	Nov 18	Oct	**2.0%**	2.0%	1.8%	Stable unemployment rate in October (LabMin forecast) and stabilization of employment in manufacturing. Seasonally strong trade and construction.

In Focus / Macroeconomics

Higher inflation and PMI in October

Last week brought two interesting macroecomic releases: FinMin's inflation forecast and purchasing managers index for the Polish economy (PMI).

Contrary to market expectations, PMI index increased from 54.7 to 55.6 points. Component of current production grew by over 2 points indicating rising momentum in manufacturing and simultaneously denying concerns of slowing economic activity in the second half of the year. Such a strong increase of PMI index suggests higher than previously anticipated dynamics in industrial production in October (in 2010 monthly increase of PMI was in 65% of cases connected with monthly growth of seasonally adjusted index of industrial production). That is why we estimate the annual growth of industrial production in October at 9-10% instead of previously stipulated 8.5%. Mid-term wise, substantial PMI growth makes sub 4% GDP forecast for H2 somewhat misplaced (see the graph below and potentially promising, enormous gap yawning between PMI and GDP).



Inflation forecast revealed by Ministry of Finance was also surprising. According to FinMin's forecasters, October's inflation increased from 2.5 to 2.9% versus expectations situated at 2.8%. We asses that growth was higher due to energy, food and cigarette prices, although Ministry did not reveal the details of their estimates.

As usual, after these publications, many MPC members expressed their opinions. Most dovish was the opinion of Chojna-Duch, who does not see the risk of permanent inflation growth and as a result – the necessity of fast monetary tightening. She is also not afraid of zloty weakening. Similarly mild in his opinions stays Kazimierczak, who claims that one should be sure that inflation growth is permanent before increasing interest rates. Higher risk of inflation pressures and the necessity of correction in households' expectations was expressed by J. Winiecki, who claims it was too early for interest rates increase in August (he did not voted in favor of a hike, indeed), although it is now high time for such a move to be considered. Zielińska-Głębocka claims that interest rates increase to 4% should be sufficient, although she did not indicate when it should happen. Definitely for fast monetary tightening is Gilowska, who claims that inflation pressure is going to increase in the forthcoming months. Also hawkish – as usual in recent months – was Rzonca. He indicates that stronger zloty should not be taken for granted. Moreover, in current circumstances the role of interest disparity somehow faded and it is a good reason to monitor exchange rate developments more carefully. On inflation front, he sees constant risks, articulated by the latest inflation projection.

MPC decision context in November seems to be similar to the one from October. On the one hand we observe strong momentum in the economy and increasing inflation (for now only headline CPI is growing, core inflation is stable, so persistence of inflation increase does not seem– for some MPC members - confirmed). On the other hand, among MPC members there are general fears about zloty strengthening and the consequences of low interest rates environment abroad. Such fears have recently gained on importance after FOMC decision – it seems the zloty is the one of many beneficiaries (overall risky assets) of global money abundance. In this globally affected decision context it repeatedly seems that Belka's line of reasoning will take the upper hand. Although the November decision (no hike) may be another close call, the sequence of macroeconomic data (most of all growing from month to month inflation) does not allow for reduction of monetary tightening expectations. Steepness of FRA curve should also last, which is reinforced by the risk of late MPC reaction for mounting inflationary pressures.

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	3.50	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	3.50

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

Fixed Income

Turning point

After the quite rapid pullback on the yield curve resulting from rather dovish MPC meeting outcome at the end of last week, the market still believes tightening cycle would start this year. To our surprise the FRA contract level topped the highest levels this year after the quite aggressive trading and quite substantial turnover from the very beginning of this week. Though the October's MinFin CPI forecast released on Tuesday, that sparked the bearish sentiment again, showed the 2.9% figure it shouldn't have been any surprise to the market. But it was…actually.

There could be few reasons for that. The front end of the curve receivers who were taking advantage from the quite steep curve on a carry trading got frightened by the fact that the possible rate hike would have adversely affect their assets (you never question stop-losses), especially when the business year is about to end. On the other hand the more hawkish comments from the MPC after the CPI October's forecast might trigger some speculators and payers to push the curve up. All this seemed to be really obvious but…the 1x4s FRA topped 30bp over current Wibor rate, 6x9s topped 80bp and 9x12s over 100bp respectively with 1y1y fwd traded 150 over. Concluding…Among all rational circumstances, entering the outright paying position at this levels, on a such steep curve turns to be EXTREMELY IRRATIONAL. It doesn't have any value and doesn't make sense at all as we cannot see neither economic nor political reasons for pricing more than 150bp rate hikes within the next 2years. Moreover, if the November MPC decides to hike, the curve must be flatter, if not we won't see any threat of a tightening until February's new CPI projection. In both scenarios 2y5y is too high. Regarding the current level of 2Y IRS at 4.91% it would be better to recv 5Y outright then.

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

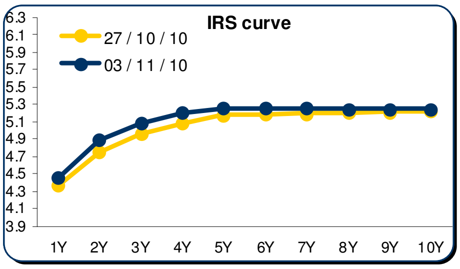
Huge surplus but the carry relatively high

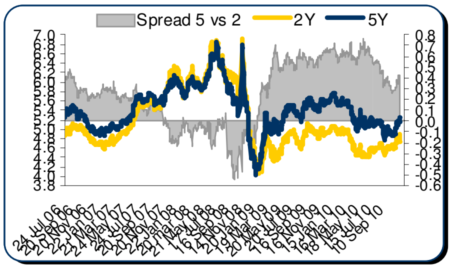
Cheap end of the reserve caused by the low demand for money bills during the last settlement day (pln 71 bln against 78.5 bln on the offer). The difference made the surplus for the new reserve at around pln 8 bln. Despite this surplus cost of carry was relatively high and just below 3%. There is also high probability that tomorrow market buys much more bills and the shortest rates will go up 30-40 bps.

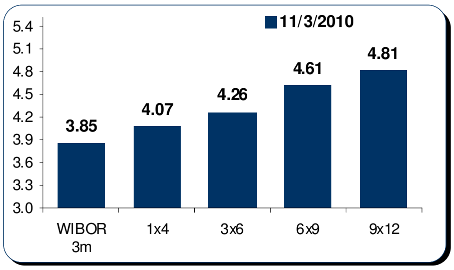
Bearish no matter what

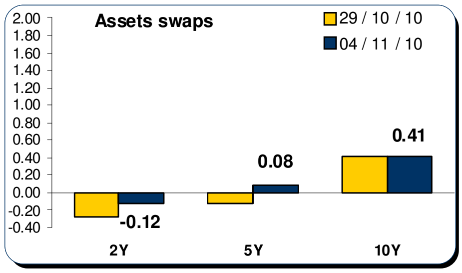
Bearish triggered by the higher than expected MinFin's CPI forecast (2.9%) and not even smoothed by the really strong pln, especially after the Fed's decision. We think that MM derivatives curves are quite overpriced, since with such a strong pln our estimation for the rates hike probability is close to zero this month. If this would be the case, next possible hike timing should be probably set up in February.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Zloty has been getting stronger entire week, while waiting for Fed QE 2.0 announcement, and the event itself only fueled the move. On Tuesday market has opened slightly below 3.96 (last Friday's high 4.00!) and finally has found support at 3.89 late Thursday. In the PLN FX background, one has to remember about the higher than expected CPI number, which is slowly translating into PLN rate hikes expectations.

Curve normalizes

EURPLN curve has started this week with very strong bids for the short end. As could be expected, the event was disappointing from the point of view of EUR/PLN realized volatility. Weekly realized vol was at 7.0 – so the market has sold off its long gamma and implied curve has come back to former shape: 1M - 10.5, 3M – 11.0, 1Y – 12.1. Stronger Zloty has also put some pressure on RR's run where 3M 25D benchmark was traded at 2.3 (2.5 last week) and currency spread - 3M USDPLN vs. EURPLN has slipped down from 7.35 to 7.1 spread.

Short-term forecasts:

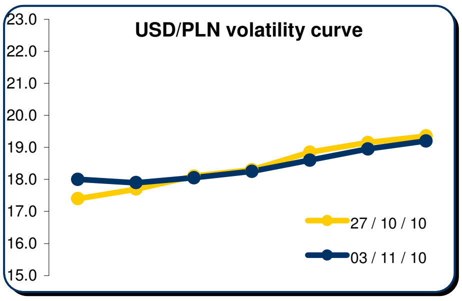
SPOT

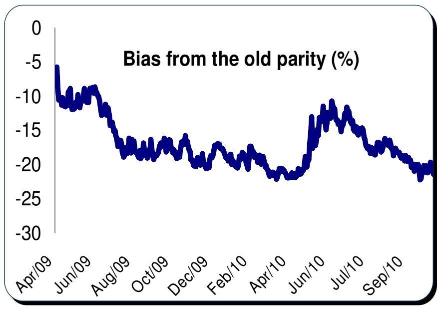
Main supports / resistances:
EUR/PLN: 3.8900 / 3.9800
USD/PLN: 2.7900. / 2.9000

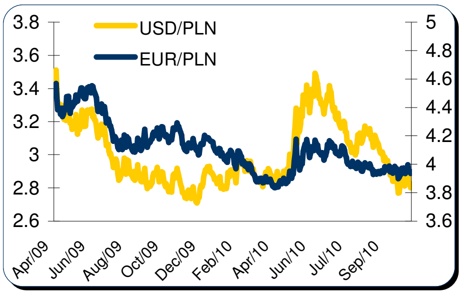
Local sentiment is even more optimistic… but 3.89 has not been broken yet (which increases chance of staying in trend). We are still Zloty positive – Fed money and possible rate hike are on pros side… but if there is not enough ammunition? Important levels stay almost the same. 3.97 (4.01 for S/L and 3.89 P/T).

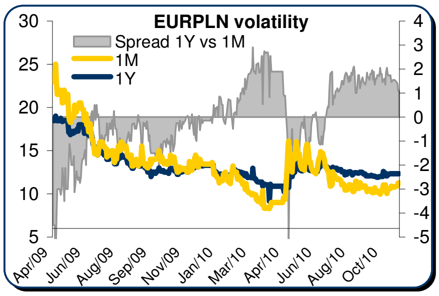
OPTIONS
The short gamma position is performing well, we would expect the underlying tendencies to continue. We also prefer to be neutral/ slightly short Vega. We also feel that, the period of increased USDPLN volatility has ended – there seems to be no further potential for USD/PLN gamma to rise.

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
27/10/10	3.72%	3.86%	3.90%	3.95%	4.17%	4.17%
28/10/10	3.72%	3.86%	3.94%	3.96%	3.93%	6.59%
29/10/10	3.80%	3.85%	4.00%	6.49%	4.20%	4.16%
02/11/10	3.75%	3.85%	4.04%	3.95%	4.34%	4.16%
03/11/10	3.74%	3.85%	3.95%	3.95%	4.15%	4.16%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
27/10/10	4.04%	4.20%	4.50%	4.69%	4.67%
28/10/10	4.08%	4.22%	4.53%	4.73%	4.65%
29/10/10	4.08%	4.17%	4.49%	4.69%	4.64%
02/11/10	4.06%	4.15%	4.46%	4.65%	4.63%
03/11/10	4.04%	4.19%	4.49%	4.70%	4.64%

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
27/10/10	4.17%	4.02%	4.75%	4.49%	5.18%	5.05%	5.22%	5.63%
28/10/10	6.59%	4.01%	4.73%	4.49%	5.15%	5.05%	5.20%	5.63%
29/10/10	4.16%	4.00%	4.73%	4.45%	5.15%	5.02%	5.20%	5.62%
02/11/10	4.16%	4.12%	4.88%	4.78%	5.26%	5.40%	5.28%	5.69%
03/11/10	4.16%	4.12%	4.90%	4.77%	5.26%	5.34%	5.25%	5.65%

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
27/10/10	17.70	18.30	18.85	19.35	2.50	4.20	0.65	0.87
28/10/10	17.95	18.35	18.85	19.35	2.60	4.20	0.65	0.87
29/10/10	18.00	18.30	18.85	19.35	2.50	4.25	0.65	0.88
02/11/10	18.05	18.30	18.80	19.35	2.50	4.25	0.65	0.88
03/11/10	17.90	18.25	18.60	19.20	2.50	4.25	0.65	0.87

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
27/10/10	2.8567	3.9446	-20.7%
28/10/10	2.8728	3.9725	-20.1%
29/10/10	2.8873	3.9944	-19.7%
02/11/10	2.8297	3.9519	-20.9%
03/11/10	2.8010	3.9339	-21.4%

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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