



## POLAND WEEKLY REVIEW

### MACROECONOMICS AND FINANCIAL MARKETS

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#### PREVIEW: The week of December 17<sup>th</sup> 2010 to December 23<sup>rd</sup> 2010

Indicator	Date of release	Pe-riod	BRE forecast	Consensus	Last	Comment
Industrial output y/y	17 Dec	Nov	10.0%	9.6%	8.0%	No difference in working days, higher PMI and positive auto production speak for acceleration from 8.0% y/y last month.
Producer prices y/y	17 Dec	Nov	4.6%	4.4%	4.0%	Higher oil and copper prices, neutral EURPLN developments.
Core inflation	21 Dec	Nov	1.2%	1.2%	1.2%	Another month with flat core...
MPC Decision	22 Dec	-	3.50%	3.50%	3.50%	We expect no change. MPC is waiting for investment activity to accelerate. Meanwhile, stable core and low wage growth grants good excuse to stay on hold.
Retail sales	23 Dec	Nov	9.0%	9.0%	9.0%	Strong substitution effects in anticipation towards VAT hike and the change of tax rules.

## In Focus / Macroeconomics

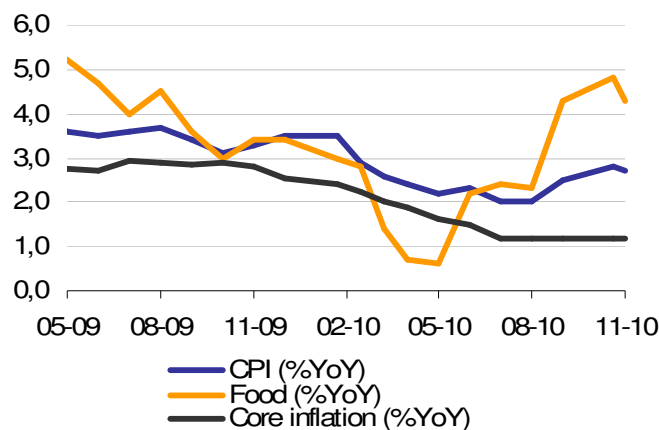
### Lower inflation, weaker employment, interest rates to be left intact till Q2

The key macroeconomic release of the week was undoubtedly data on November CPI inflation. Annual rate of inflation dropped slightly in November to 2.7% YoY from 2.8% YoY in October. The November figure turned out lower than both market consensus (2,9%) and the MinFin forecast (2,8%). The unexpected decline of consumer price dynamics in November was related to two factors: 1) lower increase of food prices (+0.2% MoM), in contrast with November food price growth in Hungary and the Czech Republic and the "hump-shaped", quite stable, after-shock transmission scheme, 2) price drops in transports (-0.2% MoM) related to falling prices of passenger cars (-0.7% MoM) connected, in turn, with the sale of old 2010 models. Other categories were fairly stable (as in October): housing and energy (-0.2% MoM), recreation and culture (0.2% MoM), communications (0.0% MoM), hotels and restaurants (+0.3% MoM), which places core inflation for the fifth month in a row at 1.2% YoY.

November inflation data do not bring any relevant evidence of rising demand pressure. However, the situation may change in the coming months. Inflation will be pushed up at the beginning of 2011 due to VAT rate hike as well as hikes of administrative prices (related to poor fiscal situation of local governments). Moreover, price pressure will be gradually generated by secondary effects of increasing cost pressures (strong rise of producer prices) and still relatively weak PLN exchange rate.

We expect CPI inflation to stick to its rising trend in the coming months, directly as a result of fuel price hikes (and probably food prices as well, in line with global trends) and later under the influence of the above-mentioned factors that build up core inflation. At the end of 2010 CPI inflation may slightly exceed 3.0%YoY (MinFin's forecast is similar), after which in H1'2011 it may approach the upper limit of the NBP inflation target.

The data on labor market did not change the picture at all. Employment was in line with expectations and extended recent trends whereas wages were probably distorted by bonuses in mining (usually paid between November and December but unsynchronized within companies what blurs the overall picture).



Last week brought only few statements of the MPC members that did not add much new information in terms of future interest rate path expectations and confirmed that chances for a fast rate hike in the coming months are slim. Rzonca – the well-known hawk within the MPC – named three main potential sources of inflation pressure: 1) easing of financial discipline of enterprises, 2) excessive growth rate of mortgage loans, 3) lower potential GDP with relation to its pre-crisis growth. In turn, Chojna-Duch confirmed her dovish stance saying that the stability of monetary policy is very important and that current risks to inflation are balanced and interest rate level adequate to economic situation. It is also worth emphasizing that the new director of the NBP Economic Institute Slawinski (former MPC member) stated that he does not notice any relevant increase of wage pressure or rising unit labour costs and that recent fluctuations of the zloty

exchange rate should not affect monetary policy.

Minutes from November meeting imply that the view expressed by Slawinski makes up for a quite good representation of the dovish sentiment that currently dominates the majority of the MPC (including the NBP Governor Belka). Taking this into account, we think first rate hikes will most probably be postponed at least till March-April (March meeting will be the first after the release of the next inflation projection as there is no meeting in February). As far as market expectations are concerned, the FRA curve prices in the first 25bp hike already in January.

### MID-TERM FORECATS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.8	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	-2.8	-3.8
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	4.2	4.5
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

### Christmas time part I

With holiday season and end of year around the corner market activity and liquidity have been deteriorating constantly. Any trading that actually took place was quite random and little chaotic and all happened within a narrow 3-4bp range. Economic data published this week, even though normally would be supportive for the curve (CPI +2.7% y/y, notch lower than market expectations and corporate wages growth at 3.6% y/y), were totally ignored. As minutes from last MPC meeting show, motions for both 25 and 50bp hikes were voted and failed, as apparently majority of Council members still doesn't see significant inflationary pressures, and somehow current data (including still very low and stable core CPI) support that point of view. It's hard to expect the market activity to pick up anyhow this year, however we don't exclude some erratic moves on the curve. As we're quite positive for rates from current levels for reasons we've been pointing out for a while (dovish MPC, low core CPI, stable growth, relatively high yields, steep curve and so on), we'd suggest receiving rates in case any upticks actually happen.

### 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	12/25/2010	-	4.056%	10/25/2010
2Y T-bond OK1013	1/5/2011	-	4.798%	12/1/2010
5Y T-bond PS0416	1/5/2011	-	5.137%	10/13/2010
10Y T-bond DS1020	1/12/2011	-	5.772%	11/17/2010
20Y T-bond WS0429	1/12/2011	-	6.170%	9/15/2010

## Money Market

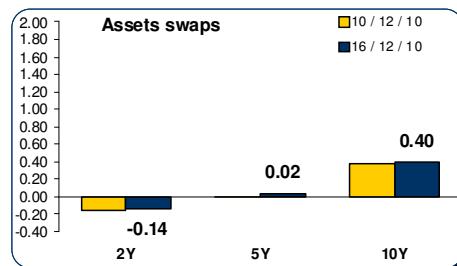
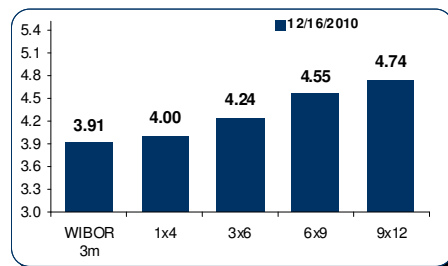
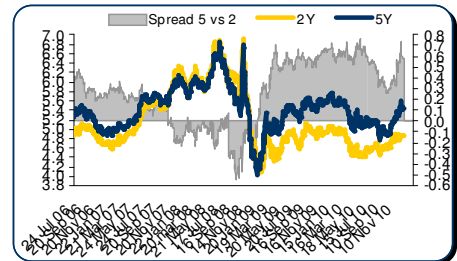
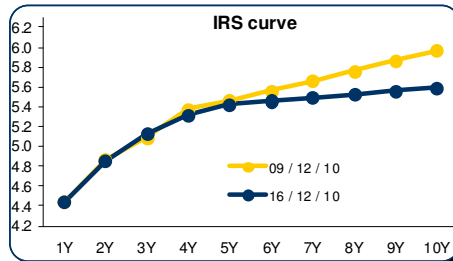
### Temporary squeeze may be more persistent, all up to next OMO

Squeeze on cash markets due to last OMO. Market bought all PLN 86.4 bln of money bills as a result of falling carry from the very beginning of the reserve requirements settlement period. This amount was absorbed despite the forecast by the NBP, which was showing shortage of the money in the system for about PLN 2 bln. If market does not wish to be squeezed before and maybe even after the Christmas (depending on the potential further shortage period and the scale) demand during tomorrow's auction should be reason driven.

*Bullish figures without reflection in prices*

**FIXED INCOME & MONEY MARKET CHARTS**

No substantial change for the longer terms (up 2Y) even after better CPI and wages figures (accordingly 2.7% vs 2.8% and 3.6% vs 4.4% expected). The hike expectations are now too high or timing to soon comparing to the current figures, their projections or/and the currency value.



**Foreign Exchange**

*Zloty stronger*

It was a good week for the Zloty, which was gradually gaining strength against all major currencies. The main cross EUR/PLN is close to 3.9800 in comparison to last Thursday 4.0470 high. Calmer core markets, stable EUR/USD, smaller than expected budget deficit, all the above have contributed to the stronger Zloty. We do not expect any stronger move as the year end and Christmas period keeps investors away from the market.

*Volatility lower*

The historical volatility has dropped dramatically, and the front end of the curve got given as a result. Only the poor pre-holiday liquidity translates the fact, that we haven seen, the deeper sell off, 1m ATM 10.25% was given today (10.75% mid last Thursday). In contrast, the back end of the curve is holding really well and we had a trade at 1y ATM at 12.3%. The currency spread (USD/PLN against EUR/PLN) hovers just above 8%.

**Short-term forecasts:**

SPOT

Main supports / resistances:  
 EUR/PLN: 3.9700 / 4.0600  
 USD/PLN: 2.9500. / 3.1000

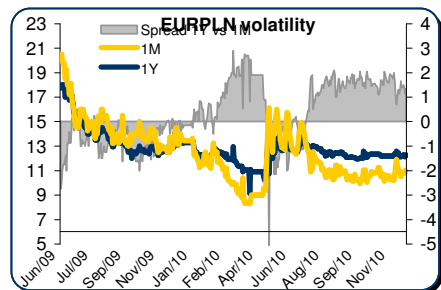
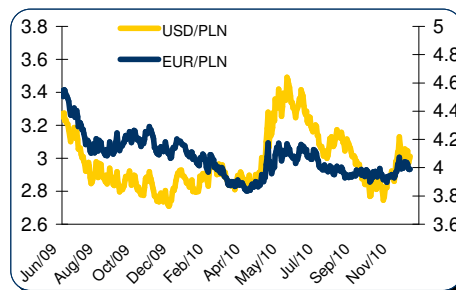
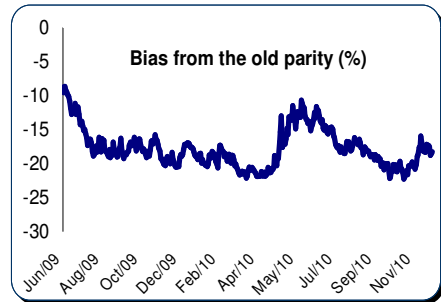
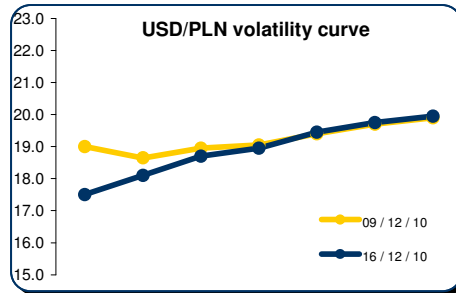
Wider 3.9500 – 4.0700 range for EUR/PLN should hold till the year end. We are eager to play that range, getting more involved on the buying Zloty side as it is more consistent with our fundamental view. On the IPO front, the Ministry has given the exclusivity in negotiations to the French investor (possible 1.2 bio EUR inflow, looming on the horizon).

OPTIONS

The implied volatility is still quite high, for example 1 week 9.75% mid versus arr. 6% historical volatility. The same logic applies to the whole front end of the curve, as the consequence, we

still stick to our core short gamma position. The USD/PLN gamma is totally different animal, we prefer to be square or slightly long in that one.

**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
10/12/10	3.78%	3.90%	4.02%	4.03%	4.22%	4.24%
13/12/10	3.81%	3.90%	4.03%	4.04%	4.27%	6.59%
14/12/10	3.81%	3.91%	4.04%	6.49%	4.25%	4.25%
15/12/10	3.81%	3.91%	4.04%	6.49%	4.40%	4.24%
16/12/10	3.80%	3.91%	4.04%	4.04%	4.24%	4.24%

**FRA MARKET RATES**

## FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
10/12/10	4.05%	4.27%	4.56%	4.76%	4.73%
13/12/10	4.06%	4.28%	4.57%	4.77%	4.75%
14/12/10	4.07%	4.30%	4.58%	4.78%	4.75%
15/12/10	4.05%	4.28%	4.57%	4.77%	4.74%
16/12/10	4.04%	4.28%	4.57%	4.78%	4.74%

**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
10/12/10	4.24%	4.05%	4.87%	4.71%	5.45%	5.45%	5.62%	6.00%
13/12/10	6.59%	4.05%	4.88%	4.71%	5.46%	5.46%	5.61%	6.02%
14/12/10	4.25%	4.05%	4.85%	4.68%	5.42%	5.46%	5.58%	5.99%
15/12/10	4.24%	4.08%	4.85%	4.69%	5.43%	5.46%	5.59%	5.99%
16/12/10	4.24%	4.05%	4.85%	4.71%	5.43%	5.45%	5.60%	5.99%

**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	10/12/01	13/01/26	90.550	4.80%	4000	9322	4076
PS0416	10/10/13	16/04/25	99.300	5.14%	3000	3414	2491
DS1020	10/09/15	19/04/25	98.383	5.46%	3000	8953	3000

**FX VOLATILITY**

date	USD/PLN 0-delta straddle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
10/12/10	18.40	19.10	19.45	19.90	3.40	4.75	0.65	0.88
13/12/10	18.60	19.00	19.45	19.90	3.10	4.45	0.65	0.87
14/12/10	18.70	19.05	19.45	19.90	3.00	4.35	0.65	0.87
15/12/10	18.75	19.05	19.45	19.90	3.00	4.35	0.65	0.87
16/12/10	18.10	18.95	19.45	19.95	3.00	4.35	0.65	0.88

**PLN SPOT PERFORMANCE**

## PLN spot performance

date	USD/PLN	EUR/PLN	bias
10/12/10	3.0458	4.0376	-17.4%
13/12/10	3.0445	4.0240	-17.6%
14/12/10	2.9708	3.9911	-18.8%
15/12/10	2.9978	3.9877	-18.5%
16/12/10	3.0125	3.9896	-18.3%

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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