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FINANCIAL MARKETS DEPARTMENT

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WARSAW, JANUARY 14, 2011

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of January 14th 2011 to January 20th 2011

Indicator	Date of release	Pe-riod	BRE forecast	Consen-sus	Last	Comment
M3 Supply y/y	Jan 14	Dec	**8.5%**	8.6%	9.0%	Trend steepening.
Wages	Jan 19	Dec	**2.7%**	3.9%	3.6%	High base in mining. Wages in manufacturing still running above 5% mark.
Employment	Jan 19	Dec	**2.2%**	2.2%	2.1%	Monthly slide, typical for December. Employment growth is flattening. Further spur as soon as investment activity picks up.
MPC decision	Jan 19	-	**3.5%**	3.75%	3.5%	More a guess or a call. The fact is macro data confirms a need for a cycle to start. Also the fact is that Belka's comments did in fact a tightening of 25-50bps (according to EURPLN appreciation effects from NBP's NECMOD model). There is no need to hurry as world financial markets remain volatile.
Industrial output	Jan 20	Dec	**11.5%**	11.7%	10.1%	Soft business tendency indicators (GUS), high PMI although export orders driven, not out driven, One working day more, Seasonally adjusted figure returning to 11% y/y.
Producer prices	Jan 20	Dec	**5.7%**	5.3%	4.6%	Commodities rising 5-10% along with PLN depreciation and substantial rise of price expectations.

In Focus / Macroeconomics

No surprise in inflation, C/A deficit widens close to record

Annual inflation hit 3.1% confirming that the earlier MoF estimate was accurate. On monthly basis, consumer prices expanded by 0.4% although most core categories had difficulties breaching 0.2% mark. The main driver of inflation were fuel prices (+5.1% m/m), whereas food prices remained stable (exactly 0.0% - matching MoF estimate), contrary to the data flowing from wholesale markets and the evidence supplied by our econometric models based on business activity indicators.

Although base effects drove core inflation higher towards 1.5% from 1.2% a month ago, truly demand driven inflation signs are hard to pin down yet. The picture may change evolutionary in coming months as core inflation will be extensively driven by state-controlled prices, VAT hikes and various feedback effects connected with costs of services and other cost-related issues. Taking into account the additional pressure exerted by commodities (food, oil) and stable growth of the Polish economy, CPI inflation may rise in coming months (with the utmost importance of core inflation). However, the second half of the year may bring some ease owing to relatively strong base effects (food price shock form 2010) and the aftereffects of zloty appreciation (according to NECMOD model 10% PLN appreciation, all other things equal, brings the annual CPI growth down after four quarters by about 1.4%). However, all this would be insufficient (given the fundamentals) to bring inflation below 3.0% in the year end.

November saw a widening of C/A deficit to EUR 2286mln from 1217mln recorded in the previous month. It is the second highest reading since 2000. Deficit widening stems primarily from two aggregates: solid deepening of negative trade balance towards EUR 1254mln and negative current transfers account. Let's deal with them in turn.

Drop in exports is nothing extraordinary in November and the final result was close to the forecast from our econometric model based on actual data supplied earlier. It is acceleration of imports what is responsible for trade deficit widening (on annual basis imports sped up to 27% y/y after 20% in the previous month). However, there is also nothing strikingly extraordinary in reading since the divergence with the forecast from our econometric model lies within less than a standard deviation. High imports growth reflect nothing more than a solid growth in consumption in the final quarter of the year – we used to elaborate extensively on various substitution effects which drove retail sales abruptly sky high at the end of the year. Situation is set to come back more to normal in coming months (2011) as growth of import will come back more in line with the pace of export. As for the current transfers account, it is of exogenous (almost administrative) nature: EU contribution was high in November, which is unlikely to be continued month by month.

Sharp widening on C/A deficit (one has to be aware, however, that at least EUR 500mln should be credited to exogenous factors only) shows imbalances in the Polish economy, namely fast rising consumption. It is doubtful argument in favor of fast rate hikes, but indeed it is another factor proving that some cooling of the economy may be necessary. However, acceleration of consumption is temporary (in such a scale and in a such short period) and would be back to "normal" in 2011; what is more, investors (which are responsible for the majority of additional deficit financing in November) are still willing to hold Polish assets at current yield levels. January MPC meeting will be a close call but we expect rates to stay on hold. On the one hand, Belka's comments generated PLN appreciation which effect may be close to a 25-50bp hike. Moreover, calmness in financial markets seems still more a wishful thinking than a current state of affairs.

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	-3.1	-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	4.25

Indicator			2010		2011	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	3.0	3.5	4.2	4.5	4.2	3.8
Inflation rate (%, average)	3.0	2.1	2.6	2.9	3.3	3.4
NBP repo rate (end-of-quarter)	3.50	3.5	3.5	3.50	3.75	4.00

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

Fixed Income

Consolidation

The market traded around its new highs within a quite decent volumes both sides. Although the technical resistance pushed the curve a little bit lower (2y from 5.15% to around 5.10%-5.12% and 5Y from 5.60% to around 5.55%) the still existing tightening cycle begin threat didn't manage to force any further downside move. The CPI data that was presumed to be the main market driver this week and was released in line with the market consensus at 3.1% and had no real impact on a curve. The bond market lost slightly its ground especially in longer maturities as a yield curve re steepened trading from 48 to 62 points 2y10y spread.

The Jan MPC meeting is crucial and is likely to pave the way. After the 3.1% CPI data we believe there is almost 50-50 chance of 25bp hike in January. As the curve has priced a hike this month, another in March, possibly in April, than in May and this scenario we consider almost impossible to happen we think it's opportunity now to get some value from being received on FRA contracts before the meeting. Especially when the next decisive one is held in March and the CPI peak is predicted in April-May period that would give only 50-75BP rate hikes in a whole cycle.

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	2/2/2011	-	4.056%	10/25/2010
2Y T-bond OK1013	2/9/2011	-	4.984%	1/5/2011
5Y T-bond PS0416	2/9/2011	-	5.642%	1/5/2011
10Y T-bond DS1020	2/16/2011	-	6.210%	1/12/2011
20Y T-bond WS0429	2/16/2011	-	6.246%	1/12/2011

Money Market

Cost of carry above the money bills yield

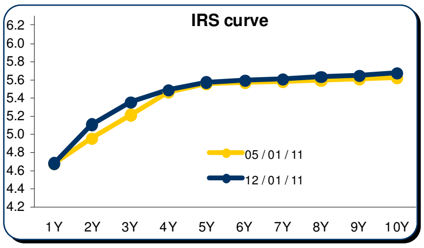
Polonia index on highest levels for the very long time

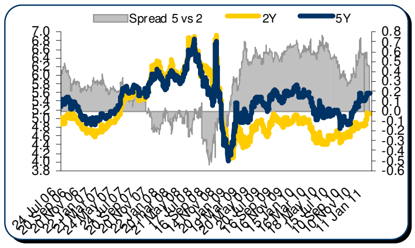
CPI in line with expectations

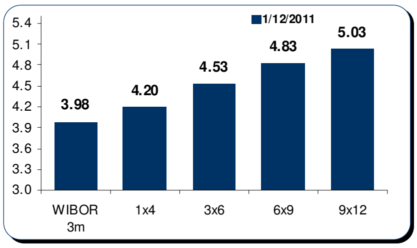
Squeeze for liquidity at least as for standards for the massively over liquid system like ours. Cost of carry was higher then the yield for the money bills that market happily bought in the record amount of pln 90.5 billion last Friday. Taking into consideration the lack of the economic validity of such a strategy plus shortage of the cash of around pln 5 billion (to keep the reserve requirements), we can assume that tomorrow's OMO will be underbid. The question is in what scale and if a scale turns out to be huge if the central bank decides to organize additional OMO next week. All in all the market is searching for the new deviation of the polonia index comparing to the main market rate. This spread narrowed to 25 bps in January comparing to 75 in December. In our opinion it should widen again to around 40-50 bps.

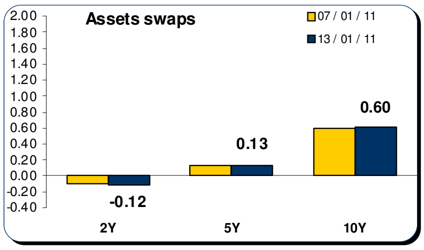
Crucial figure this month (CPI) was exactly in line with expectations. Next figure we are waiting for are wages (we have a bit lower forecast then consensus), and then the MPC decision on Wednesday. 25 bps hike is already discounted in all MM curves. We still see the probability 40/60 in favour of no hike this month.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty trading stronger side

This week market was surprised by MPC member Bratkowski foreseeing EURPLN rate by the end of year at 3.50. Result? New low has been drawn (3.8350) and once again it was followed by sharp take profit (3.8850). A week ago those numbers were 3.85 and 3.91. Does it mean that just short term money are involved in PLN so far? It may. Anyway EURPLN is located still in strengthening trend and common market target is still placed at 3.70.

Implied curve untouched

Realized volatility still remains about 10% and that fact supports implied curve in present shape. Numerically 1M about 10%, 3M – 11.2% and 1Y 12.2%. Stronger Zloty has been reflected only in short term Risk Reversals run where 1M has been traded down from 1.9 to 1.5 and 3M from 2.7 to 2.5 while 1Y has stayed at 3.5 level.
Currency spread stays at same 8% although decreasing (about 0.0 now!!) EURPLN vs EURUSD correlation should create some pressure on short end to narrowing.

Short-term forecasts:

SPOT

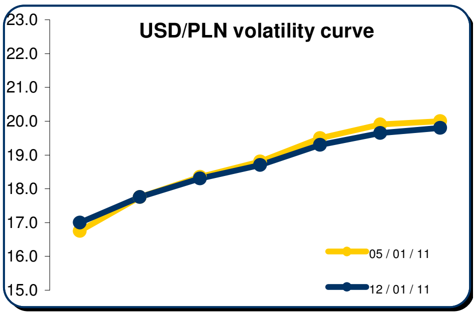
Main supports / resistances:
EUR/PLN: 3.8000 / 3.9800
USD/PLN: 2.8400 / 3.0200

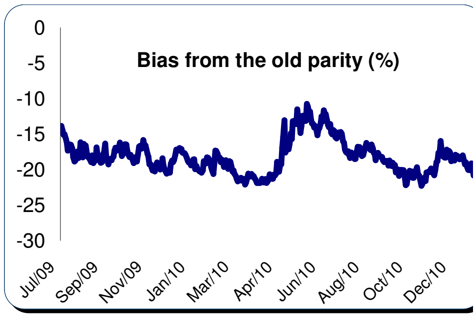
Although local sentiment looks bit weaker we are still upticks sellers. We see risk to rebound up to 3.93-3.96 area were we look for sell – S/L 4.01, P/T 3.80.

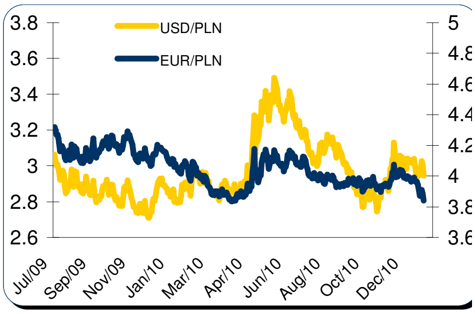
OPTIONS
Gamma prices fair enough to close shorts and be gamma neutral for a time being. Our focus shifts to longer term (above 6 months risk reversals and Vega), in our eyes we are getting to

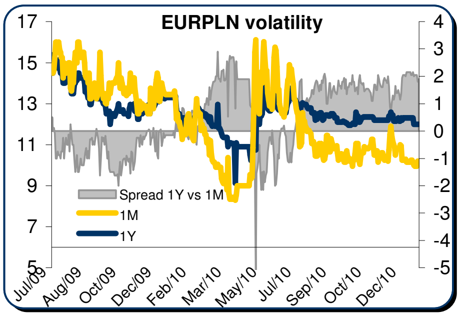
closer to attractive levels to go slightly long in both. As we do not have a decisive break of 3.80 just yet, and EUR periphery problems still looming on the market.

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
05/01/11	3.53%	3.96%	4.07%	4.06%	4.28%	4.29%
07/01/11	3.85%	3.96%	3.83%	4.08%	4.38%	6.59%
10/01/11	3.63%	3.97%	4.10%	6.49%	4.30%	4.31%
11/01/11	3.87%	3.98%	3.93%	4.09%	4.30%	4.32%
12/01/11	3.86%	3.98%	4.09%	4.11%	4.30%	4.32%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
05/01/11	4.11%	4.31%	4.62%	4.81%	4.78%
07/01/11	4.11%	4.32%	4.66%	4.87%	4.82%
10/01/11	4.19%	4.51%	4.87%	5.05%	4.99%
11/01/11	4.22%	4.51%	4.87%	5.07%	5.04%
12/01/11	4.19%	4.48%	4.83%	5.02%	5.00%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IF
05/01/11	4.29%	4.02%	4.96%	5.04%	5.56%	5.67%	5.6
07/01/11	6.59%	4.12%	5.08%	4.98%	5.54%	5.67%	5.6
10/01/11	4.31%	4.20%	5.13%	5.07%	5.59%	5.67%	5.6
11/01/11	4.32%	4.18%	5.07%	5.03%	5.55%	5.67%	5.6
12/01/11	4.32%	4.18%	5.11%	4.99%	5.58%	5.70%	5.6

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sc
52W TB	10/09/27	11/09/27	96.189	3.92%	600	1150	58
OK0113	10/12/01	13/01/26	90.550	4.80%	4000	9322	40
PS0416	10/10/13	16/04/25	99.300	5.14%	3000	3414	24
DS1020	11/01/12	19/04/25	93.022	6.21%	2250	4252	22

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		2
date	1M	3M	6M	1Y	1M	1Y	1
05/01/11	17.75	18.80	19.50	20.00	3.10	4.70	0.
07/01/11	17.55	18.85	19.55	20.00	3.10	4.70	0.
10/01/11	17.90	18.95	19.50	20.00	2.70	4.65	0.
11/01/11	17.95	19.00	19.55	20.00	2.40	4.55	0.
12/01/11	17.75	18.70	19.30	19.80	2.40	4.55	0.

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
05/01/11	2.9476	3.9095	-20.0%
07/01/11	2.9818	3.8730	-20.1%
10/01/11	3.0268	3.9082	-19.1%
11/01/11	3.0065	3.8858	-19.6%
12/01/11	2.9466	3.8403	-20.9%

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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