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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

FINANCIAL MARKETS DEPARTMENT

PAGES: 11

WARSAW, FEBRUARY 11, 2011

PREVIEW: The week of February 11th 2011 to February 17th 2011

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A balance mln EUR	Feb 11	Dec	**-1638**	-1568	-2286	Trade deficit slightly lower. The dominant driving factor is current transfers account which retreats from negative territory recorded due to large EU contribution in November,
CPI Inflation YoY	Feb 15	Jan	**3.3%**	3.4%	3.1%	VAT hike and state-controlled price hikes. Czech inflation data confirm food prices lower than implied seasonally (about +0.7% m/m).
Wages YoY	Feb 16	Jan	**5.0%**	5.1%	5.4%	Low base effect in mining. Wages in manufacturing running above 5% mark.
Employment YoY	Feb 16	Jan	**2.9%**	2.6%	2.4%	Under the influence of annual sample change. Net enterprise creation and growth should support an upward revision.

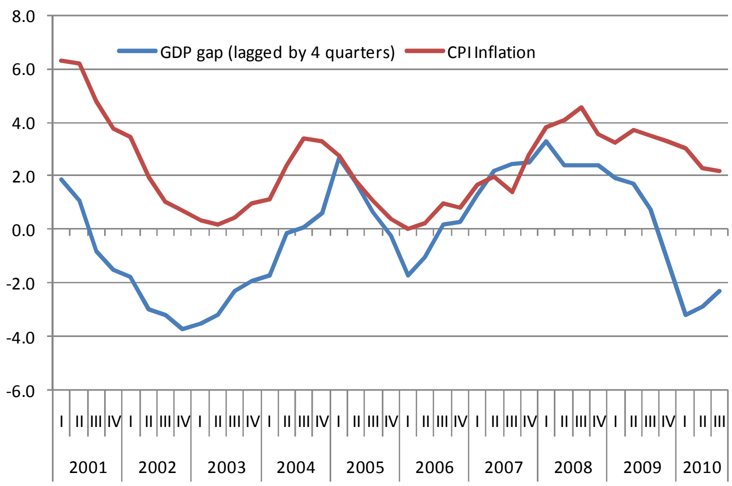
In Focus / Macroeconomics

Polish inflation will rise but not as far as market interest rates imply

Inflation's rise in the forthcoming months may be treated as given. Undoubtedly, demand pressure is growing and VAT hike effects along with rising commodity prices will soon be visible. But should we expect such a significant increase in inflation that financial instruments are pricing? According to our calculations, the built-in interest rate path would require a rise in inflation towards 4.3% YoY over the coming quarters which seems a level out of reach, especially given our estimates which imply that most of supply shocks have been already reflected in CPI index. Therefore, we treat monotonically rising inflation path in the whole 2011 as a low probability scenario and the same applies to the scale of tightening priced-in in FRA rates.

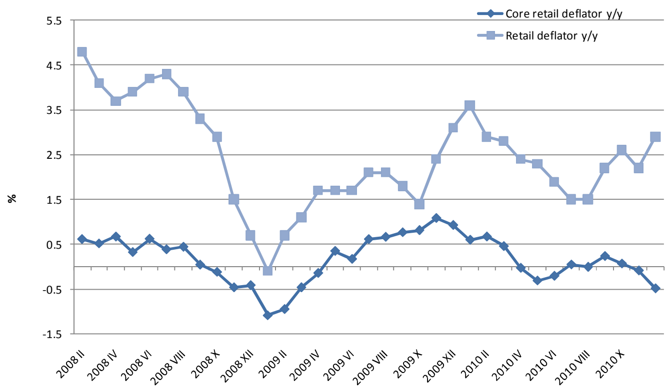
Inflationary demand pressures – still only in terms of risks
Polish economy enters mature recovery phase with all cyclical consequences it entails. For a few months one could have observed rises in employment, real wages and consumption. Manufacturing production and capacity utilization have been growing systematically as well. In these circumstances, rising inflation would be a natural consequence (see the graph below).

Chart 1. GDP gap and CPI inflation



It should be stressed that cyclical demand pressures should be regarded still only in terms of future risks, not facts. What is more, current diagnosis of price pressures made on the basis of retail sales deflator (excluding fuel and food prices) indicates that during the last months price growth in demand categories even decreased! Therefore we conclude that inevitable inflation growth (also in core inflation in the beginning of 2011) will be only slightly due to inflationary demand pressures (at least in the nearest, predictable future) and would mainly comprise of exogenous factors: base effects, VAT hikes and (erratic) behavior of state-controlled prices.

Chart 2. Retail sales deflator and core retail sales deflator (excluding fuel and food sales)

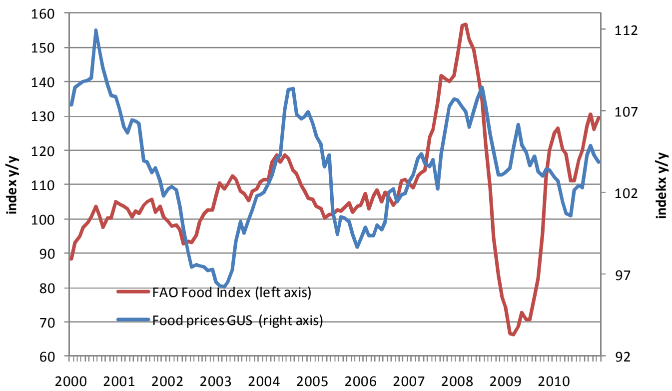


Food price shock and after

Even those treating demand pressures as a future risks would dig into actual rises of inflation to look for factors that may shape (in a sustainable basis) inflation expectations. However, credible threats in this field are hard to pin down as well.

First of all, the scale of food price growth is relatively small compared to previous food price shocks. What is more, despite the fact that global price tendencies (as reflected by the FAO Food Index) are correlated with price changes in Poland, the amplitude is different (Chart 3 – mind that both measures are projected on different Y-axes). Therefore we do not see an inflationary overhang in food prices, which could explode anytime soon – it seems shocks absorption mechanisms work unexpectedly well in the Polish economy.

Chart 3. Dynamics of FAO food price index and GUS food price index



Econometric analysis points that food price shocks have little ability to build-in in inflation index. More precisely, food price shock (which we define as sudden, unexpected inflation increase of one standard deviation upwards for one quarter – currently it stands at about +1,9pp.) quite rapidly disappears in the whole inflation index: about 31% of the whole shock raises CPI index immediately (that is just a little more than food weight in the inflation basket, because other components also react as food is a vital cost component of many services rendered), another 12% a quarter later and 6% two quarters later – there is no statistically significant evidence that shocks remain in CPI index longer than three quarters. What is more, when gradually reducing sample of the model to most recent observations, we see that the scale of shock impact on inflation (cumulative response of inflation to food price shock) decreases monotonically, which means that Polish economy becomes more elastic (absorption mechanism works better over time) or additionally, monetary policy becomes more credible, which allows for solid anchoring of inflation expectations.

Summing up, occurrence of food price shock can not only be ascribed little probability, but also seems neutral in terms of its consequences and pass through to overall CPI index (shock is in 50% absorbed, vanishes quickly and generates base effect next year).

Investors are afraid of inflation growth

Entering the mature recovery phase, weaker than expected zloty, global supply shocks and passive MPC became a strong reason for investors to count Poland as another country having problems with controlling inflation. Such a reasoning resulted in significant steepening of FRA rates and rising bond yields (across whole yield curve, which seems a little panic). Recent valuations of those instruments can be interpreted as a series of rate hikes to 5.25-5.50% over two years. In spite of the fact that hikes' scale is similar to those in Czech, Euroland, Izrael and Korea, higher current rates makes monetary tightening in Poland more severe.

When we compare the market rate evaluations with MPC reaction function estimated on historical data (modified Taylor rule), it is consistent with future inflation at 4.3% (holding exchange rate equal, and deriving GDP growth expectations from Reuters and Bloomberg polls). If we allow exchange rate to appreciate (in line with current market expectations) CPI would have to rise towards 5% in order to make the market-expected rate path consistent with MPC reaction function.

Chart 4. Realized WIBOR3M (blue) and its FRA implied path (red), quarterly average.

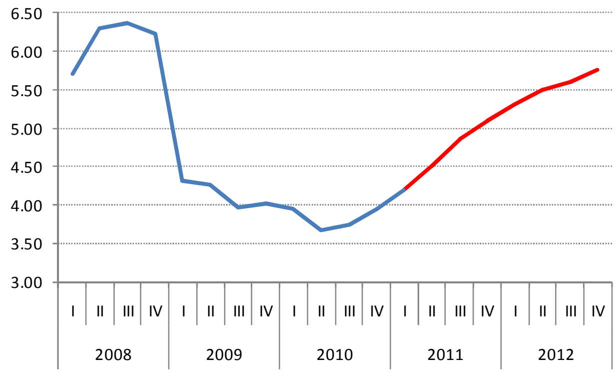
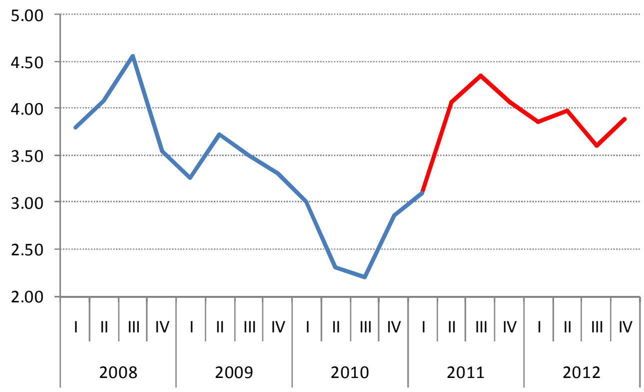


Chart 5. Taylor rule derived CPI path, assuming FRA implied interest rate path, market forecasts of GDP dynamics (Bloomberg, Reuters) and constant exchange rate (historical CPI in blue, derived in red).



Is the risk of inflation growth above 4.3% a dominant one? Currently, there is little strong evidence supporting such a reasoning. Firstly, there is still a lack of signs of demand pressures (see part 1). Secondly, identified mechanism of supply (food price) shocks propagation suggests fast and deep shock absorption in the Polish economy. Thirdly, realization of supply shocks in the second half of 2010 implies fairly large base effects in the second half of 2011; therefore monotonically rising inflation path would be very hard to achieve. Similar base effects will be generated by VAT hike from the beginning of 2011. Finally, we assess that investors do not include in their evaluations two probable anti-inflationary processes: 1) zloty strengthening, 2) (even limited) fiscal consolidation. Therefore we claim that implied set of extremely negative inflationary risks is exaggerated and tightening cycle will be much more moderate.

Budget borrowing needs for 2011 – picture not as gloomy as portrayed by many

Last days saw several reports, press articles and remarks by MPC members as well highlighting negative fiscal story for the Polish economy. Economists focused primarily on unquestionable lack of genuine austerity measures in Poland and changes in the Polish Pension system (slashing the contribution from budget to private pension funds) leading to relatively less favorable funding structure of state's budget – from now on the state is to fund its borrowing needs relying to a larger extent (percentage wise) on the offshore investors. Some of economists went in their suggestions so far that they indicated a possibility of Poland's default and problems in servicing debt at market rates higher than 7% (see MPC member A. Kazmierczak).

Although we do not see Polish fiscal consolidation path as a rosy one, the prospects of significantly lower than assumed borrowing needs in the months to come (see the piece below) may ease now uniformly expected negative market effects.

To start with, the Ministry of Finance managed to prefund 8%, i. e. almost 13 bn of its 2011 gross borrowing needs estimated initially at PLN 167.5bn already by the end of 2010. Slashing contribution to private pension funds, effective from May, will also lower state's borrowing needs by additional 14bn in 2011. As an important source of funding the budget deficit we also see a transfer of the central bank's profit. Due to zloty depreciation against the US dollar and lower yields on core markets (yields on asset hold by the NBP decreased by 60bps within 2010) **NBP 2010 profit may beat very modest MoF estimates included in the budget bill (PLN 1.7bn) and amount to 6-10bn, significantly boosting the 2011 budget revenues as well.** In effect, the **central budget deficit may decrease from planned PLN 40.2bn to as low as 35bn.** The borrowing burden may be also eased by higher than assumed 15bn sale of state-owned assets. We estimate that privatization revenues may well rise to above 20bn this year. Thus, **the gross borrowing needs may be in 2011 as low as PLN 141 bn vs 193.5bn recorded in 2010.**

As Ministry of Finance is very likely to obtain its usual EBI and World Bank credits (4bn worth of each) and to continue to sell T-bills at an usual pace (up to PLN 40bn for 2011) and foreign bonds (PLN 23 bn) it will have to issue no more than 45bn worth of bonds, and no more than 35-40bn of which will be fixed rate bonds (it already sold PLN 13 bn worth of such bonds). All in all, **the average monthly supply will thus shrink to below 4bn as compared to 8.5bn in 2010**. It seems thus that from pure liquidity perspective Polish MoF is to withstand the mounting market pressure and via bond supply management reduce the risk of significant yield pick-up. The 7% yield mark named by one of the MPC officials as a critical for Polish ability to service its debt is not an outcome of any advanced simulation. To be honest, it seems a bit out-of-the blue. As a counter-argument one would wish to look at the issue at a more systematical way: Poland with its nominal growth of above 7% y/y is much more likely to service its debt than developed economies growing be mere 2% plus in nominal terms, isn't it?

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	3.4
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	12.3	**11.9↑**
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	3.4	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

What is really priced in a yield curve ?

Last week the PLN yield curve stayed quite resistant to both worlds' and domestic political and economic issues. After the Min Fin Marczak's announcement the Ministry might have intervened the longer dated debt yields by offering to the market 5y and 10y IRS, the long end of a curve was trying to find its new equilibrium flattening the curve to 2y5y spread from 54 to even 40 points and 5y10y to around 2-3 points. What's interesting, the foreign investors almost completely forgot its last year main strategy to cover domestic risk by paying 5y5y fwd PLN rate over EUR pushing the spread to around 135 point, lowest till April 2010. Neither hawkish Gronicki and Hausner press article nor MPC Glapinski dovish market comments could have changed much the overall stance of the investors view about the substantial interest rate rise necessity in Poland this year. The article that stressed the strong need to adopt the quick combined fiscal and monetary tightening in Poland had the same market impact as the Glapinski's comment about the possible current necessity of monetary policy restriction. The Central banker surprised the market a little bit by releasing quite dovish statement that Poland was likely to see one or at most two small 25bp hikes in the 2H of a year taking into account both current CPI and economic growth tendencies. That was no surprise to us as it strictly corresponded to our main 2011 market scenario presented from the very beginning of this year.

Concluding... the yield curve has already priced almost the worst possible scenario quoting the 6M FRA contract over 75bp and 9M contract over 95bp over current Wibor rate at 4.09%. The 2Y IRS at 5.15% that implies forward rates at 5.25% in 12M, 5.40% in 15M, 5.53% in 18m and 5.63 in 21m makes another 60bp tightening that results in over 150bp interest rate rise priced in a curve within the next 21 months. The question is.... is it profitable to pay that scenario?

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	2/28/2011	-	4.056%	10/25/2010
2Y T-bond OK1013	3/9/2011	-	5.031%	2/9/2011
5Y T-bond PS0416	3/9/2011	-	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

T-bills stable during the tender

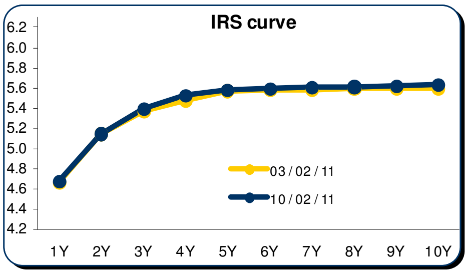
Some dovish comments from the MPC members pushed the curves lower

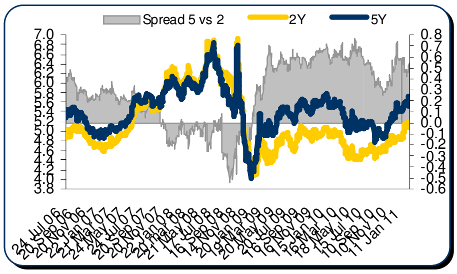
Cost of carry stable just above 3%. Surplus of the cash in the system as of now reaches pln 1 billion and today the central bank will certainly try to sterilize it during the open market operation. We can expect the supply of the money bills at around 90 billion pln.

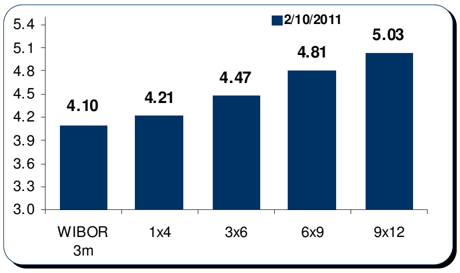
Benchmark T-bills stable during the auction with an average yield of 4,33% which was only 2 bps lower then for previous issue of the same paper. On Monday we can see those papers a bit more expensive.

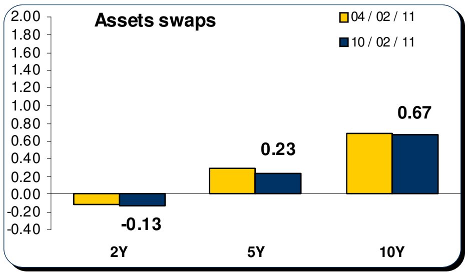
This week bullish sentiment was triggered by some MPC members with dovish statements suggesting overpriced the cycle itself as well as the timing. OIS curve dropped 10 bps on average, and as of now no hike in March is built in.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This year's long PLN positioning was cleared out and Zloty has ceased to be one of top trades. Last week's top (3.96) was quickly followed by this week's bottom at 3.8450 and EURPLN's rate has finished week about 61.8% retracement of this move (3.92) trading a bit worse on European sentiment. As both positioning and liquidity are at low levels, trading wide, choppy range is natural consequence of this fact.

Implied curve offered

Although trading above 3.90 levels has lowered the number of vega sellers, curve still stays at this year's lowest levels – 1M about 9.2, 3M 10.2 and 1Y 11.5. To complete the picture – weekly realized vols stays, despite wide range, at low 9% reading and only noticeable reaction we have faced on smile where 1Y 25D RR is continuously heading lower – 2.8 as against to 3.1% in last week. USDPLN vs EURPLN spread has not unchanged its 6.3% level.

Short-term forecasts:

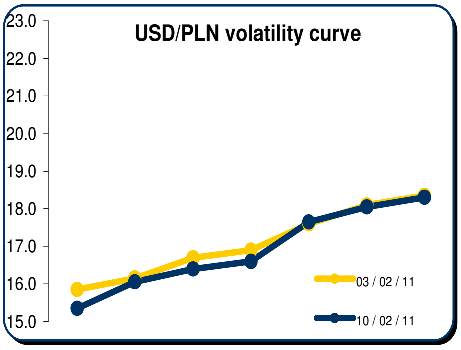
SPOT

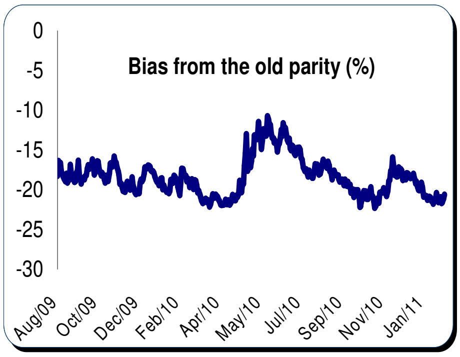
Main supports / resistances:
EUR/PLN: 3.8400 / 3.9600
USD/PLN: 2.8000 / 2.9200

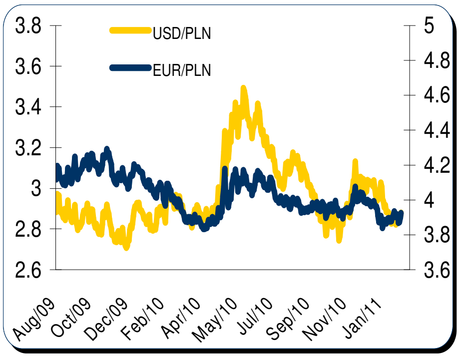
We have closed our 3.96 short at 3.86 and now we are awaiting 3.94 to reenter it.

OPTIONS
Vega is priced lower (1Y tenor 12.3 to 11.5 since 1st of Jan!) and it is hard to convince us to catch running train. On the other hand, long, cheap (1W about 9.0-9.5) gamma may be proper response for low underlying liquidity (increased probability of higher realized readings).

FX CHARTS


USD/PLN volatility curve
23.0
22.0
21.0
20.0
19.0
18.0
17.0
16.0
15.0
03 / 02 / 11
10 / 02 / 11


Bias from the old parity (%)
0
-5
-10
-15
-20
-25
-30
Aug/09
Oct/09
Dec/09
Feb/10
Apr/10
May/10
Jul/10
Sep/10
Nov/10
Jan/11


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
Aug/09
Oct/09
Dec/09
Feb/10
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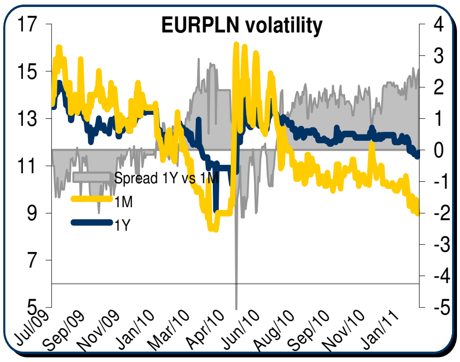
May/10
Jul/10
Sep/10
Nov/10
Jan/11


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
17
15
13
11
9
7
5
4
3
2
1
0
-1
-2
-3
-4
-5
Jul/09
Sep/09
Nov/09
Jan/10
Mar/10
Apr/10
Jun/10
Aug/10
Sep/10
Nov/10
Jan/11

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
04/02/11	3.85%	4.09%	4.13%	4.22%	4.36%	4.40%
05/02/11	3.96%	4.09%	4.06%	4.23%	4.27%	6.59%
08/02/11	4.00%	4.10%	4.20%	6.49%	4.40%	4.40%
09/02/11	3.90%	4.10%	4.20%	4.22%	4.40%	4.40%
10/02/11	3.98%	4.10%	4.13%	4.22%	4.32%	4.40%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
04/02/11	4.15%	4.48%	4.82%	5.03%	4.96%
05/02/11	4.15%	4.47%	4.83%	5.04%	4.99%
08/02/11	4.23%	4.47%	4.83%	5.04%	4.99%
09/02/11	4.22%	4.45%	4.83%	5.03%	4.99%
10/02/11	4.23%	4.45%	4.82%	5.03%	4.99%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IF
04/02/11	4.40%	4.40%	5.15%	5.03%	5.54%	5.83%	5.6
05/02/11	6.59%	4.40%	5.15%	5.03%	5.54%	5.83%	5.6
08/02/11	4.40%	4.36%	5.14%	5.06%	5.54%	5.81%	5.6
09/02/11	4.40%	4.33%	5.17%	5.04%	5.58%	5.82%	5.6
10/02/11	4.40%	4.36%	5.15%	5.02%	5.59%	5.82%	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
04/02/11	16.15	16.85	17.65	18.35	2.50	4.50	0.
05/02/11	16.15	16.85	17.65	18.35	2.50	4.50	0.
08/02/11	15.90	16.65	17.60	18.25	2.50	4.50	0.
09/02/11	15.90	16.70	17.60	18.30	2.50	4.50	0.
10/02/11	16.05	16.60	17.65	18.30	2.50	4.50	0.

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
04/02/11	2.8666	3.9075	-21.0%
05/02/11	2.8666	3.9075	-21.0%
08/02/11	2.8471	3.8742	-21.6%
09/02/11	2.8581	3.8993	-21.2%
10/02/11	2.8795	3.9248	-20.6%

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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