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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of March 18th 2011 to March 24th 2011

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Current account mln EUR	**Mar 21**	**Jan**	**-1709**	**-1380**	**-1573**	After recent GUS data we would have said that the risk is towards significantly narrower C/A deficit. However, NBP's fiddling with publication date demands caution as errors and omissions account may be distributed among recorded C/A categories or (equally bad information) NBP is going to comment on the provenience of errors and omission account (i.e. mostly unreported imports). Expect the unexpected.

Core inflation y/y	**Mar 22**	**Feb**	**1.9-2.0%**	**2.0%**	**1.6% (Dec)**	Publication encompasses January and February reading. Is is probable that core inflation stayed flat at 2.0% or slightly below.
Retail sales y/y	**Mar 23**	**Feb**	**7.2%**	**7.3%**	**5.8%**	The dampening effect of auto sales somehow subsided. We expect a gradual acceleration towards sustainable 10-11% trend.

In Focus / Macroeconomics

Intriguing reschedule of BoP publication

A few hours before balance of payments data release deadline (March 14, 2:00 PM) NBP unexpectedly announced rescheduling to March 21. Official explanation points to a need of verifying the list of entities which have reached the reporting threshold in 2011.

It is hard to name a single more intriguing event than this postponement. Accelerating pressure on Polish Zloty (partially due to an increase in global risk aversion) has been boosted by this event and investors' and analysts' speculations about possible substantial revisions in balance of payments data. The issue here are huge net errors and omissions (exceeding 3.5% of GDP). One possible explanation points to REPO or FX swap transactions aimed at financing Polish bonds, which are hardly identifiable by the central bank. This hypothesis explains relative weakness of Zloty due to investors activity on the bond market without simultaneous exposition to Polish currency. It does not, however, substantially change the assessment of the Polish economy fundaments. Second, and more likely in our opinion, hypothesis points to NBP's difficulties in estimating the volume of Polish imports (the German foreign trade data seems to support this hypothesis). Huge underreported imports is to increase the trade gap and C/A gap. Thus, Poland would be an example of typical economy with twin deficit problem (budget deficit and current account deficit). It would also radically change the assessment of how the Polish economy works. It cannot be any longer seen as a country with healthy balance of payments benefiting from a huge an improved price competitiveness in foreign trade. On the contrary, it may turn out that Poland is not Asian economies alike, the savings are not rising and the economy needs to import a lot to satisfy consumers needs. We have doubts whether this model may be seen as sustainable In a post-crisis word and thus expect zloty to stay weaker in order to balance the economy.

Back to the 21st March data release, it would be naïve to expect a complete explanation of the net errors and omissions issue. The most likely scenario is only a limited NBP data revision and sustained high level of net errors and omissions.

Lower than expected inflation rate in February

Annual inflation rate stabilized at 3.6% level (GUS revised both weights in inflation basket and reading in January from 3.8% to 3.6%). As far as basket revision is concerned, the only significant change was in "housing" category, where prices rose in 2010. Usually in such cases substitution effects occur, but in this particular case such a possibility can be treated as almost impossible (what is a substitute for housing or renting?) – so we end up with higher weight for housing in consumption basket. Among other categories there were only little movements on weights, with no significant tendency – they are presented in the table below.

		New weights	**Old weights**
Food and non-alkoholic beverages	-	24	24,1
Alcoholic beverages and tabacco	~	5,7	5,7
Clothing and footwear	+	5,2	5,1
Housing, water, electricity, gas and other fuels	+	20,7	20,1
Furnishings, household equipment	-	4,9	5,2
Health	-	4,9	5,1
Transport	-	9,1	9,2
Communications	-	4,5	4,7
Recreation and culture	+	7,8	7,7
Education	~	1,2	1,2
Restaurants and hotels	+	6,8	6,7
Miscellaneous goods and services	~	5,2	5,2

As far as price changes are concerned, dynamic increases in several categories from January diminished. Food prices rose only by 0.7% m/m, "housing" category by 0.3% m/m, prices in all other categories oscillated around 0-0.5% m/m, which means that VAT hike influence was mainly visible in January. Annual core inflation rate probably did not reach 2% level in January and February; demand pressure still does not seem disruptive.

Although in forthcoming 2 months inflation may surprise on the upside due to higher food and energy prices, time of correction is looming (inflation is expected to top out in April/May and then begin to slide down).

Employment remains strong

Wages grew in February by 4.1% yoy (compared to 5.0% in January), less than expected. Taking into account high and growing employment growth, lower wages dynamics does not mean a change in trend but only a one-off (in such sections as mining). In the months to come we expect 5 to 6% wages growth, supported by sustainable economic recovery, affecting also the labor market.

Employment in the enterprise sector grew in February by 4.1% yoy. Interestingly, the monthly change in employment turned out to be very high: 12k. More interestingly, had the change been only slightly higher (by literally only a few dozens), the employment would have grown by 4.2%. Although sectoral decomposition of employment requires further analysis on the basis of more detailed data (to be released soon), enterprises appear to be much more willing to employ than we thought earlier basing on the data published before December. This fact perfectly corresponds with a turnaround in employment indicators enclosed in business tendency surveys. If the current tendency is sustained, we may see acceleration in employment even before H2 2011. Persistent job creation at around 12k would make it possible for the employment to grow by about 5% in the end of 2011.

Significant increase of industrial production in February, high PPI

Industrial production rose by 10.7% yoy in February 2011, after 10.1% in January. Seasonally adjusted production reached 9.8% yoy after 8.4% in the previous month. Such a high growth highlights still lasting economic recovery, which may be a surprise for MPC (as we deduce from simultaneously published “Minutes” from March meeting). Production data stay also in contrast with decreasing PMI value.

Main driving forces of Polish industry are still export categories. Increase in production was recorded in 26 (out of 36) industry categories, the highest in manufacturing of other non-metallic mineral products (+34.8% yoy), manufacturing of metal products (+29.6% yoy) and manufacturing of motor vehicles, trailers and semi-tailers (+24.7% yoy). Exactly in these categories capacity utilization is the highest, which bring them very close to a more pronounced investment activity.

The structure of production growth makes us conclude that: 1) there is a strong German demand within intra-industry relations between both economies, 2) manufacturing has done enough for looming strong rebound of construction and assembly production (owing to the strong growth recorded, among others, in manufacturing of non-metallic mineral products which in our opinion was mostly stock-piled at the level of construction companies), 3) the base for the recovery in Polish industry remain wide, with lots of categories recording constant growth.

Increasing business tendency indicators for the German economy imply that Polish industry momentum in Poland should remain stable during the forthcoming months. What is more, recovery in the labor market (better perspectives for employment means also higher probability of realization of household consumption plans) should soon affect manufacturing. Finally, considering the mature phase of economic cycle and stable domestic demand, manufacturing will benefit from construction (annual growth in February rose from 10 to 23% yoy) and gradually arising investment in machines and equipment. GDP growth should reach 4.2% yoy in the first quarter of 2011.

As far as construction output is concerned, one can be optimistic as increases in all sections were reported. Although construction of buildings increased by 10.3% yoy, this lower growth was compensated by high specialized construction activities dynamics (43.9% yoy) together with civil engineering (27.0% yoy). Such decomposition of growth points to sustained 20% growth in the months to come, as preparation of construction of buildings has been growing fast. Although annual comparisons are biased due to harsh winter in the first quarter of 2010, two-digit mom growth leaves ground for limited optimism as far as construction production in March as well as gross fixed capital formation in the first quarter are concerned.

Producer prices grew by 7.3% yoy, while there was no revision of January data (6.2%). Producer prices accelerated to 1.0% mom. This increase is mainly a result of increases in manufacturing, where prices grew by 1.1% mom. In mining and water and electricity supply price growth amounted to 0.2-2.0%. In core manufacturing (excluding prices of coke and refined petroleum products which are determined by exogenous factors), on the other hand, prices grew by 0.9% which constitutes one of the highest numbers since Autumn. Current pressure on commodity prices makes it impossible for the PPI to fall in the months to come. Even if petroleum and food prices shocks turn out to me temporary, high price expectations of producers (trend seems to be upward) together with structurally weaker zloty will keep the price pressure on producers' side flying. Current CPI data suggests however, that profitability buffers are relatively high (and cost elasticity probably even higher) because until now there has been no impact of PPI on CPI. It seems that it is an argument for MPC to remain modest in interest rate increases.

Rates outlook

Just after the publication of weaker (at least for MPC) wages and lower inflation, and taking into account the recent rate-setters' statements it seemed the April decision would be more or less flip of a coin. However, at the end of the week MPC members became very hawkish (even Kazmierczak which makes us conclude the unanimous January voting was not an incident) and thereby more willing to outpace ECB in monetary tightening. Therefore, regardless of how pity it looks, we think there is rather a greater probability that MPC will hike rates in April than it will not. We still fully back a scenario in which the additional scale of monetary tightening is limited to 50bp.

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	3.7
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	4.4	4.2	4.2
Inflation rate (%, average)	3.0	2.1	2.6	2.9	3.7	3.7
NBP repo rate (end-of-quarter)	3.50	3.5	3.5	3.50	3.75	4.25

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

Fixed Income

Strong bullish trend…but likely to reverse soon

It's been quite an interesting week on the fixed income market. It has started with further comments from FinMin, stating they're prepared and ready to start IRS transaction on the market. That, for the second time already, resulted in quite strong receiving interest, especially in the longer end of the curve. Wednesday's publication of CPI data surprised to the downside (3.6% y/y vs. 3.9% y/y estimate). Also yearly inflation basket change caused revision of a previous figure from 3.8% to 3.6% y/y. That naturally supported front end of the curve. Also the employment and corporate wages data, however strong, but lower than expectations, pushed the curve further down. Overall the curve moved down by ca. 20bp through the course of the week. From the economic data perspective, it seems quite likely that the MPC could hold the April rate hike, even though not long ago it had seemed a done deal. We were quite bullish on rates for a few month now, reiterating that levels were moving past the area that could be reasonably explained, that forwards above 6% is more than possible rate hikes, necessary risk premium and any other factors that could possibly affect them. From longer perspective they are probably still somewhere between neutral and too high. However we think in the short term there are some risks that should be considered. We think next CPI reading could surprise on the upside, weakening PLN is definitely something the Council should take into consideration when deciding on further policy moves. Therefore we decided to close our receivers, we're even quite keen to take some pay positions using this rally (especially that it's been the strongest bullish trend so far this year), as we still think we might see curve drifting higher again in the near future.

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	3/28/2011	-	4.291%	1/31/2011
2Y T-bond OK1013	4/13/2011	-	5.113%	3/9/2011
5Y T-bond PS0416	4/20/2011	-	5.642%	1/5/2011
10Y T-bond DS1020	4/20/2011	-	6.210%	1/12/2011
20Y T-bond WS0429	3/16/2011	-	6.246%	1/12/2011

Money Market

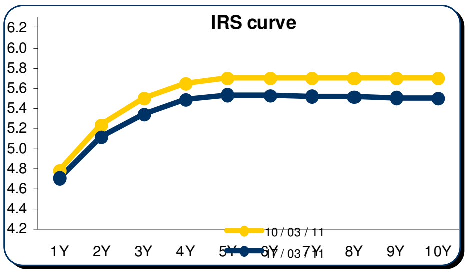
Expensive carry sustained

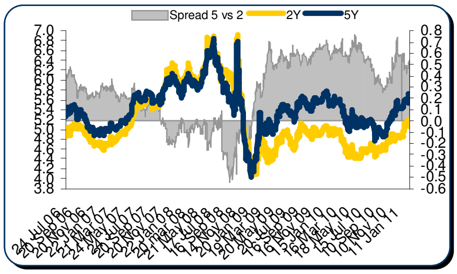
Continuation of relatively expensive cost of carry last week plus growing reserve requirements due to under built status. Polonia index is nearby the main market rate which for substantially over liquid system makes no sense and must reflect some kind of liquidity disturbance. If another week is similar we can see ON deposits above the yield of money bills. All this makes cheap end of the reserve very probably since carrying on like this will force last OMO of this settlement period to be highly underbid. Then we would approach the new reserve with huge surplus and high demand for money bills. Here circle closes and does nothing but increased volatility for deposits and ois contracts.

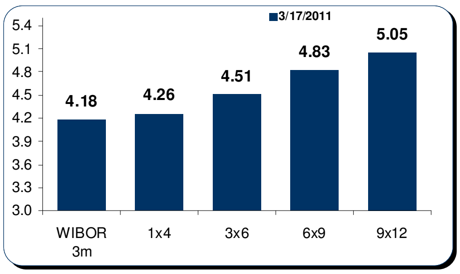
Bullish figures vs weakening PLN

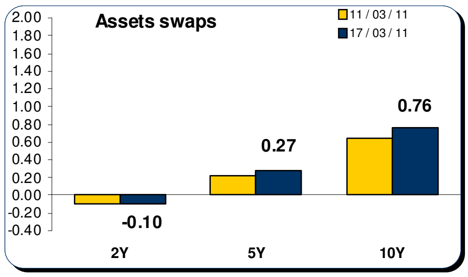
Set of bullish figures (CPI 3.6vs 3.9% expected and wages 4.1vs4.9% expected) pushed the curve down by 5-10 bps and decreased probability of rates hike in April. If retail sales will be low continuation of this rally is certain. PLN has weakened a lot as a result of global turbulences (Japan as major factor), but also as a result of postponing the current account figure issue for not clear enough reasons. Currency under pressure is now the main factor supporting interest rates.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

The EUR/PLN has broken finally the 4.00/4.0200 strong resistance zone and reached 4.1225 high on Thursday. The move was driven mostly by the global "risk off" environment (Japan Middle East), but our local factors are also not that Zloty supportive anymore. The CPI announcement will support the dovish part of the MPC, the Monday's current account announcement was postponed for the next Monday (rises a lot of speculation why). Generally Zloty perspective is bit mixed at the moment , and I tent to believe that it s will be up to the main global exchanges to guide us.

Vols higher

The implied volatility curve is off it s lows (10.55% 1year, 8.7% 1month) but, it is nothing too impressive as the historic volatility is still below the implied ones, and the market is still long after the really strong supply of the Vega in the last weeks. The current levels 1 month - 9.7% mid , 1year 10.85% mid, the risk reversals are also higher by 0.2% and the currency spread (USD/PLN vs EUR/PLN) has jumped to 5.25 % from 4.25 % in the mid of the curve.

Short-term forecasts:

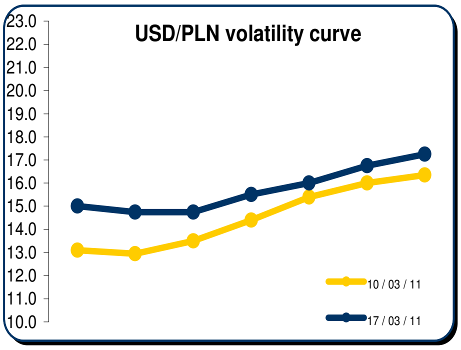
SPOT

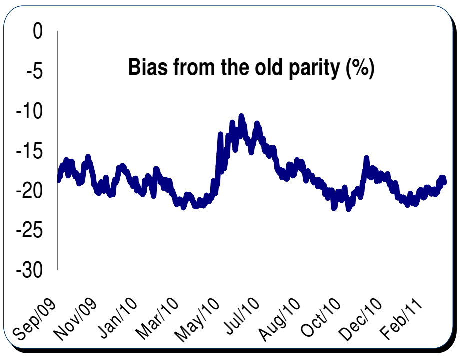
Main supports / resistances:
EUR/PLN: 4.0150 /4.1543
USD/PLN: 2.8000 / 3.0500

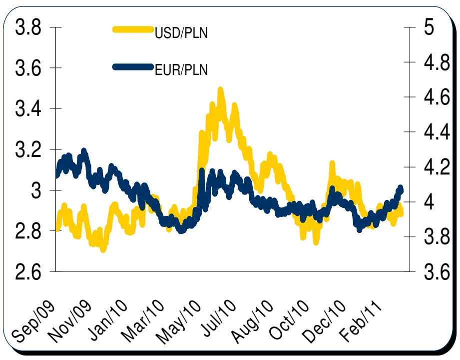
Previous Shorts in EUR/PLN stopped. The technical picture for EUR/PLN is now totally different to last week. Now 4.0410/4.0641 forms the support for EUR/PLN. We are already long from 4.0550, risking 4.0150 stop, in hope to see 4.1200 profit taking.

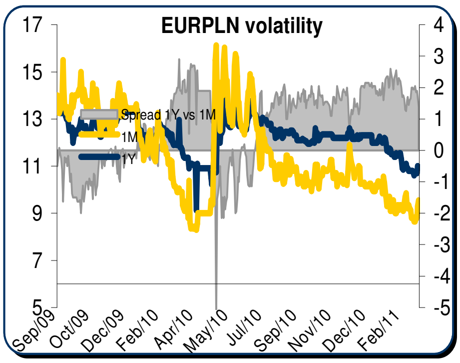
OPTIONS
Albeit historic volatility is still below the implied ones, we think that current market situation will support long volatility positions. In our opinion it is tempting to be selectively long Vega/Gamma, not in the high low delta currency calls but in plain ATMS with much healthier gamma/theta ratio. So we try to be on the bids on Vega in 3 months and 1 year.

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
11/03/11	4.08%	4.18%	4.28%	4.30%	4.45%	4.47%
14/03/11	4.09%	4.18%	4.28%	4.30%	4.44%	6.59%
15/03/11	4.09%	4.18%	4.29%	6.49%	4.46%	4.47%
16/03/11	4.09%	4.18%	4.29%	4.30%	4.47%	4.47%
17/03/11	4.09%	4.18%	4.28%	4.31%	4.46%	4.47%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
11/03/11	4.31%	4.59%	4.92%	5.22%	5.13%
14/03/11	4.33%	4.62%	4.92%	5.19%	5.13%
15/03/11	4.33%	4.59%	4.88%	5.17%	5.08%
16/03/11	4.32%	4.60%	4.89%	5.18%	5.11%
17/03/11	4.32%	4.56%	4.85%	5.13%	5.08%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		
	WIBOR	TB	IRS	OK0112	IRS	PS0511	IF
11/03/11	4.47%	4.54%	5.23%	5.12%	5.70%	5.92%	5.6
14/03/11	6.59%	4.55%	5.19%	5.08%	5.62%	5.86%	5.5
15/03/11	4.47%	4.53%	5.10%	5.03%	5.49%	5.86%	5.4
16/03/11	4.47%	4.55%	5.09%	5.00%	5.49%	5.77%	5.4
17/03/11	4.47%	4.51%	5.12%	5.02%	5.54%	5.81%	5.5

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sc
52W TB	11/01/31	12/01/31	95.841	4.35%	2000	2968	19
OK0113	11/03/09	13/01/26	91.054	5.11%	4500	10808	45
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
11/03/11	13.55	14.75	15.70	16.35	1.60	3.70	0.
14/03/11	13.60	14.80	15.70	16.35	2.15	3.70	0.
15/03/11	14.10	14.75	15.80	16.70	2.30	3.95	0.
16/03/11	14.35	15.05	15.80	16.60	2.30	4.00	0.
17/03/11	14.75	15.50	16.00	17.25	2.50	3.85	0.

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
11/03/11	2.9212	4.0316	-18.9%
14/03/11	2.8825	4.0211	-19.5%
15/03/11	2.9284	4.0618	-18.4%
16/03/11	2.9052	4.0557	-18.8%
17/03/11	2.9077	4.0800	-18.5%

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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