



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of May 13th 2011 to May 19th 2011

Indicator	Date of release	Pe-riod	BRE forecast	Consensus	Last	Comment
CPI Inflation y/y	May 13	Apr	4.5%	4.4%	4.3%	Food and fuels (0.8% m/m and 2.5% respectively) are driving inflation higher. Spillover effects more and more pronounced – core inflation accelerates to 2.2% y/y.
M3 Supply y/y	May 13	Apr	9.3%	9.1%	10.8%	Last reading distorted by one-off effects and come back to recent trends in the cards.
C/A balance EUR mln	May 16	Mar	-1346	-1177	-685	Exports and imports driven by strong growth of durable goods production and high car sales. Imports slowly outpacing exports and this will result in gradual C/A deficit widening amidst the change in EU transfers nature (more capital than current transfers).

Employment y/y	May 18	Apr	4.1%	4.0%	4.1%	Last monthly drop seems to be temporary in nature and we are back to recent trends.
Wages y/y	May 18	Apr	4.6%	4.5%	4.0%	Last reading distorted by wages in mining. KGHM bonus skews the reading upwards.

In Focus / Macroeconomics

Unexpected rate hike

This week (on Wednesday) MPC hiked interest rates by 25 bp. The base rate now amounts to 4.25%. Although the decision is justified by macroeconomic risks and policy of both PLN strengthening and quicker curbing of inflation (this topic is very popular due to political reasons), it was anticipated neither by the market nor by analysts. This is a result of MPC's poor communication scheme: the hike follows quite clear signals of postponing hikes after the meeting of Rostowski and Belka, and dovish comments by the members of MPC, including NBP head, on contained inflationary pressures.

The statement after the meeting and MPC press conference turned out to be relatively hawkish and confirmed: 1) growing optimism in the real sector assessment, 2) mounting inflation risks, 3) continuation of monetary tightening in the future. During the press conference NBP head took a lot of effort to explain reasons why market did fail to assess MPC plans (this part was not appealing) and once again changed his rhetoric stressing that the environment becomes more and more inflationary – inflation rise is now a broad based phenomenon - not only prices of food and commodities have been growing, but also core inflation.

MPC decision immediately resulted in PLN appreciation (as unexpected as it was only boosted the effect of the hike). It may also be a factor supporting zloty exchange rate in the weeks to come. Communication problems of the MPC result in increasing risk of further monetary tightening in the short term. Faster, textbook-like hike reduced the risk of monetary policy error (i. e. too late reaction to self-evident inflation risks) and ultimately did not influence long term bond yields (in short term we expect that the price of long term bonds may even go further up in price).

Turning to macroeconomic perspectives, we believe that in the next quarters economic recovery in Poland will continue (investment demand should get stronger, substantial consumption growth rate will be sustained). Strong labor market, more and more aggressive labor unions bargaining and high profitability of enterprises – all make it possible to live up employees' wage expectations on a broadly basis that will result in persistently high level of inflation. The composition of inflation will change towards more persistent categories, reflecting endogenous price pressures resulting from closing of GDP gap. Such macroeconomic perspectives point to further monetary tightening this year (probably 2 more hikes) and next year. We should see the next hike either in June or July (July is more probable, as inflation projections are published that month, what is more also ECB should hike rates in July). Hawkish wing of the MPC turned out to be strong – such MPC members as Bratkowski prefer the scenario of quick hikes and an earlier end of the tightening cycle. Market expectations of rate hikes could change (decline) substantially when inflation will reach at least its local maximum (May figure) and for some time the market may ignore growing core inflation. This may then coincide with more dovish MPC rhetoric. History shows that Polish MPCs used to turn more dovish as soon as inflection point in inflation is reached.

MID-TERM FORECASTS

Indicator	2007	2008	2009	2010	2011
GDP y/y (%)	6.5	4.8	1.7	3.8	4.4
Inflation rate (% , average)	2.4	4.3	3.5	2.8	4.1
Current account (% of GDP, average)	-4.5	-5.3	-1.6	-3.1	-4.8
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	4.75

Indicator	2010				2011	
	Q1	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	3.0	3.5	4.2	4.5	4.4	4.4

Inflation rate (% , average)	3.0	2.1	2.6	2.9	3.7	4.3
NBP repo rate (end-of-quarter)	3.50	3.5	3.5	3.50	4.00	4.25

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

Fixed Income

Surprise

Unexpectedly, the RPP meeting turned out to be the most important issue last week. To the market surprise the Council decided to raise interest rates by another 25bp and released quite hawkish statement on a conference. The short end of a yield curve reacted rapidly moving rates up by 15 bp. As the market realized the Council move might aim on reassuring investors it couldn't be no longer "behind the curve", the steeper strategy we preferred for the last couple of weeks ceased to function anymore. The curve has flattened much trading 1y2y spread around 31 points and 2y5y around 34 respectively. The 5y10y sector went negative again and has inverted to around -2 -3 points with the strong receiving interest on stop losses in general. It is hard to estimate where the next CPI figure will come, but if it's accelerates and the Council would follow by more aggressive hikes the more flattening scenario would be played.

On the other hand....

As no one from the majority of the top economists expected such a RPP move it might question a credibility of the Council's communication with the market participants a little bit and make the further investment strategies like walking through the mine field. For the last couple of months the market has tried to find out the solid pattern to understand the way the RPP might act. The question was if it were more eager to react on a current macro data or like manage its monetary policy strategy following the overall future CPI path expectations. The last action showed there would be no real pattern and the further moves might turn to be quite random that would easily result in an additional risk and greater market volatility. So beware....

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	5/30/2011	-	4.458%	3/28/2011
2Y T-bond OK1013	6/9/2011	-	5.112%	5/12/2011
5Y T-bond PS0416	5/18/2011	-	5.642%	1/5/2011
10Y T-bond DS1020	7/20/2011	-	6.210%	1/12/2011
20Y T-bond WS0429	7/20/2011	-	6.246%	1/12/2011

Money Market

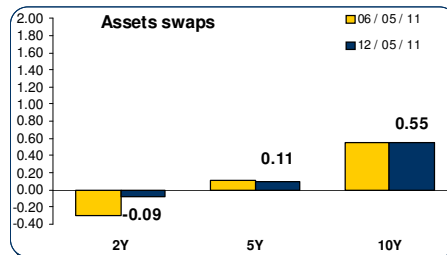
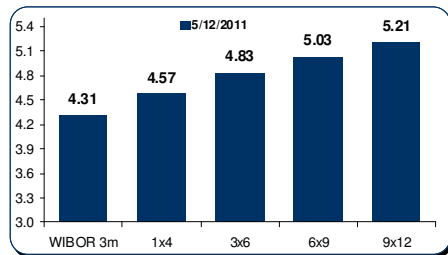
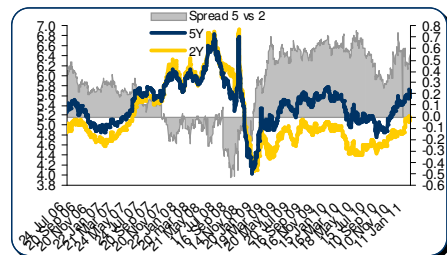
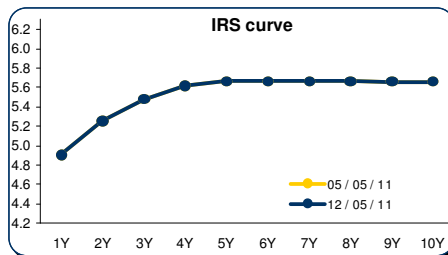
Cheap cost of carry

Relatively cheap beginning of the new reserve settlement period with the polonia rate approximately 50 bps below the main market rate. It is quite a lot taking into consideration that the cash surplus was only 1.5 billion pln. The public finance consolidation has just started and this is the most probable explanation for the situation.

All the rates up by 25 bps

The MPC hiked all the rates by 25 bps, which was surprising literally for everyone. The move itself is fully justified by last economy data, however the timing especially after last comments from the MPC members including the CEO, is not in line with so called clear market communication. In our opinion credibility of the further comments is close to zero. They are completely unpredictable and highly volatile in their opinions.

FIXED INCOME & MONEY MARKET CHARTS



Foreign Exchange

Zloty stronger

Deeds are better than words... MoF has started to distribute their resources through both channels: on direct and through electronic brokers. As a result Zloty has slipped from 3.9750 top down to 3.9250 form where surprising rate hike deepen move down to 3.89 bottom. Then, some profit taken took place but the Zloty is still supported with MOF flow.

A bit nervous trading (worse global sentiment countered by MoF flow) has elevated realized volatility to 9.7% (weekly terms). This fact plus higher major volatility curves made PLN curves better bided. Tenors were traded as specified below: 1M 8,4 (8.0 week ago), 3M 8.85 (8.7), 1Y 10.55 (10.45Smile has been traded at very same level. Better bids on EURPLN vs USDPLN currency spread has elevated traded rates up to 7.25 (next 0,25).

SPOT

Main supports / resistances:
 EUR/PLN: 3.8900 /3.9600
 USD/PLN: 2.6800 / 2.8200

Vols bit higher

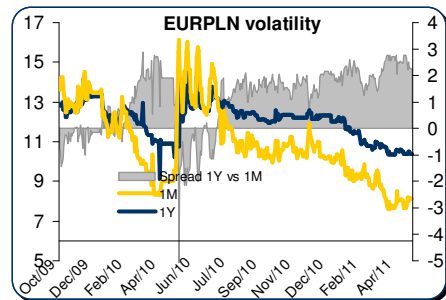
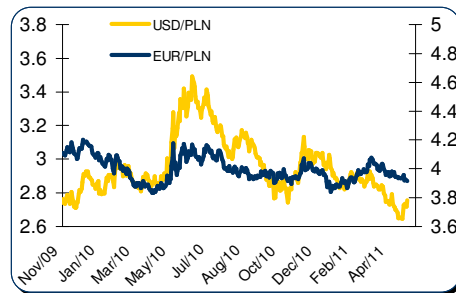
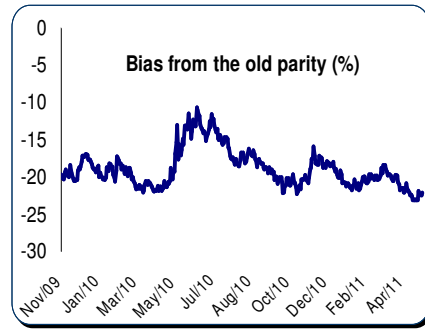
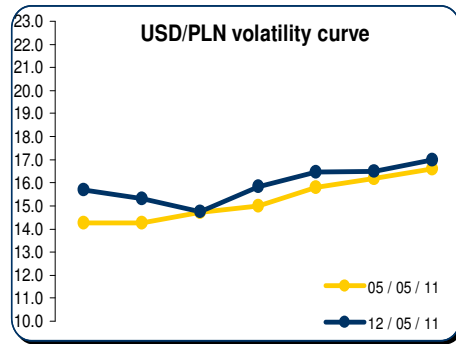
We have closed our short from 3.96 at 3.90. The Zloty should be supported by hawkish MPC and MoF flow, we would be trying to sell on upticks – 3.94/3.96, S/L 3.98, P/T 3.88.

Short-term forecasts:

OPTIONS

We think that we have already seen the lows in volatility for time being. The pick-up in main crosses would push XXX/PLN higher in it is due time. The USD/PLN is the first one to react but we believe it will affect EUR/PLN also...The Long position is Vega is also a great hedge for long PLN positions , if global sentiment deteriorates and/if MOF backs up from the direct currency sells.

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
06/05/11	4.23%	4.30%	4.42%	#ARG!	4.57%	4.57%
09/05/11	4.21%	4.30%	4.00%	4.40%	4.34%	6.59%
10/05/11	4.20%	4.31%	4.42%	6.49%	4.57%	4.57%
11/05/11	4.30%	4.31%	4.40%	4.41%	4.57%	4.57%
12/05/11	4.35%	4.31%	4.50%	4.41%	4.67%	4.57%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
06/05/11	4.46%	4.70%	5.00%	5.20%	5.17%
09/05/11	4.45%	4.68%	4.97%	5.17%	5.14%
10/05/11	4.44%	4.65%	4.94%	5.14%	5.09%
11/05/11	4.44%	4.63%	4.93%	5.12%	5.08%
12/05/11	4.46%	4.61%	4.89%	5.09%	5.07%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)						
date	1Y		2Y		5Y	
	WIBOR	TB	IRS	OK0112	IRS	PS0511
06/05/11	4.57%	4.60%	5.16%	4.86%	5.55%	5.67%
09/05/11	6.59%	4.60%	5.14%	4.84%	5.51%	5.63%
10/05/11	4.57%	4.59%	5.16%	5.03%	5.53%	5.64%
11/05/11	4.57%	4.62%	5.22%	5.09%	5.56%	5.66%
12/05/11	4.57%	4.61%	5.23%	5.14%	5.57%	5.67%

PRIMARY MARKET RATES

Last Primary Market Rates						
	au. date	maturity	avg price	avg yield	supply	demand
52W TB	11/01/31	12/01/31	95.841	4.35%	2000	2968
OK0113	11/04/13	13/01/26	89.159	5.16%	5500	7385
PS0416	10/10/13	16/04/25	99.300	5.14%	3000	3414
DS1020	11/01/12	19/04/25	93.022	6.21%	2250	4252

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR	
	1M	3M	6M	1Y	1M	1Y
06/05/11	14.38	15.10	15.90	16.70	1.85	3.65
09/05/11	14.43	15.15	15.95	16.70	2.10	4.00
10/05/11	14.58	15.25	16.00	16.90	2.10	4.00
11/05/11	14.63	15.30	16.00	16.90	2.10	3.80
12/05/11	15.30	15.85	16.45	17.00	2.15	3.80

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
06/05/11	2.7270	3.9600	-22.0%
09/05/11	2.7190	3.9215	-22.5%
10/05/11	2.7361	3.9284	-22.2%
11/05/11	2.7201	3.9193	-22.5%
12/05/11	2.7573	3.9147	-22.1%

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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