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FINANCIAL MARKETS DEPARTMENT

PAGES: 9

WARSAW, OCTOBER 2, 2008

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of October 3rd to October 9th

Indicator	Date of release	Period	BRE forecast	Consen-sus	Last	Comment
No significant releases						

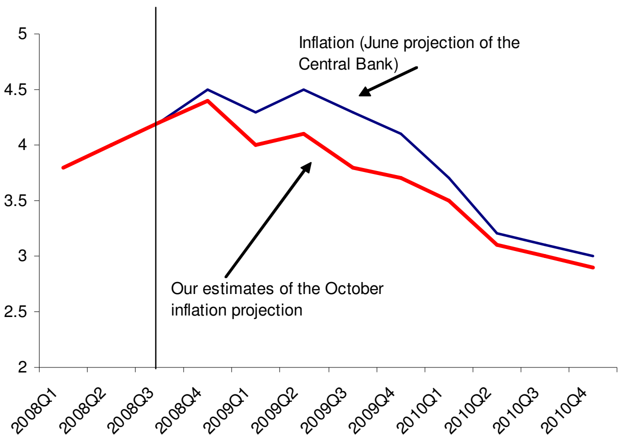
In Focus / Macroeconomics

New central bank's inflation projection most likely below the previous one – main findings of our research

In the piece below we only summarize the main findings of the research on the effects the changes in macro environment might have on the new central bank's official inflation projection.

Note that we conducted a similar research several times in the past. This time, however, our task seemed to be much less challenging, as all changes in macroeconomic environment were uniformly working in the same direction, i.e. toward lower projected inflation. In our research we subsequently quantified, based on the official central bank's econometric model NECMOD, the effects associated with divergence between the actual and forecasted (or assumed) paths of zloty exchange rates, crude oil price, core inflation, unit labor costs, food prices and market interest rates.

1. Between the projection cut-off dates, the zloty has appreciated by more than 2% which, based on the published impulse-response functions, can lower the 2009 projected inflation by 0.2 pctg points.
2. In contrast to the previous projections (i.e. before NECMOD was introduced), the most recent ones has correctly envisaged the developments on the labor market including stabilization of the unit labor costs dynamics, in particular. Thus, we do not see this variable to additionally skew the future inflation.
3. Between cut-off dates, the market interest rates rose by 70 bp which, based on the NECMOD, may lower the 2009 projected inflation by 0.1-0.15 pctg. points.
4. The crude oil price path used in the new inflation projection, as indicated in the newly released "Monetary Policy Assumptions for 2009", is to be shifted downwards by approximately 15% as compared to that used as an input in June projection. Lower oil price may additionally lower headline inflation by 0.35 pctg points in 2009.
5. Food prices are said (once again "Monetary Policy Assumptions") to remain on an elevated level, but ease a bit in terms of growth rate. Such a behaviour of prices (along with adjustments on the supply side) should be less pro-inflationary than in the last projection.
6. Prices of energy are likely to resemble the path presented in June as consumer watchdog failed to deregulate the market for energy form 2009 on.
7. Fiscal policy is said to be less expansive than in the current year but fiscal tightening may be counterbalanced by softer results of government on the local level (as we read in "Monetary Policy Assumptions for 2009"). Thus we treat the fiscal policy as neutral for the inflation path.
8. Our main trade partners (euro zone in particular) are expected to grow at a much lower pace (1% in 2009 versus 1.5% in previous projections). The exact impact of this change is hard to quantify without explicitly solving the model, however, it certainly moves the inflation path downwards.
9. Finally, the changes in projection inputs (zloty exchange rate in particular) listed above are also affecting the core inflation in 2009. And this, through a channel of adaptive expectations incorporated in the NECMOD, will also lower the 2010 inflation path.



Conclusions:

• Changes in macroeconomic environment (which have taken place since the last projection) have made us considerably level off the forthcoming inflation path.

• Lower oil and food prices, firmer zloty and higher interest rate level are going to lower CPI inflation and core inflation, mainly in 2009.

• Hence, apart from the factors we mentioned several times (cyclical slowdown, lower "observable" inflation which reduces the risk of second round effects, relatively strong zloty), the forthcoming inflation projection is going to be, contrary to arguments uttered by the other analysts, a factor reducing the need for further monetary tightening. **We expect that the borrowing costs will stay at 6.0% in October.**

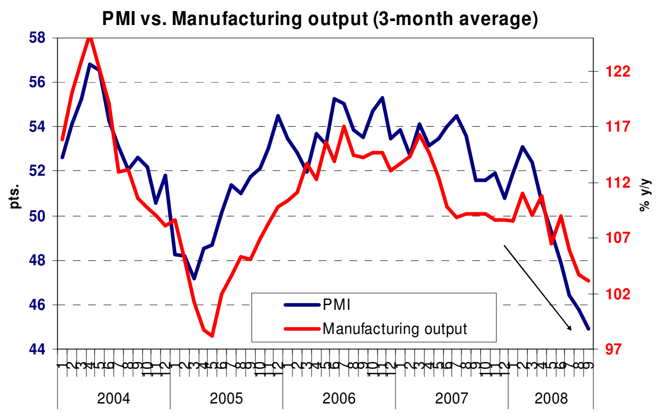
Finance Ministry's inflation forecast at 4.4%

The Ministry of Finance forecasts inflation at 4.4% y/y in September. The figure falls into the interval of the so called "conservative forecasts": not too optimistic and not too pessimistic either. We expect inflation to reach 4.3% y/y owing to moderate growth of food prices and the ongoing downward correction in fuels. At the same time we expect the feedback effects from overall economy to be still limited: core 'net' inflation is likely to reach 4.1% y/y whereas its counterpart excluding food and all energy is set to rise to 2.8%.

As usual, the publication encouraged some MPC members to comment on future monetary policy (to be honest, they were unusually quiet since the last meeting). With the absence of firm macroeconomic data, the comments became surprisingly hawkish. M. Noga and H. Wasilewska-Trenker would happily apply one more hike to the economy (even two in case the latter members). The same view seems to be shared by A. Slawinski: such a move would help to restore the "right" growth proportions of the economy (whatever this means). M. Noga also suggested that the majority of members await October inflation projection. It is then hard to imagine that this majority would opt for a hike in the forthcoming meeting as inflation projection will be lower (the view shared even by the hawks). This sort of the puzzle has been partially resolved by J. Czekaj, a well-known swing-voter, who thinks the economy may not need any more hikes. We expect then the MPC to cease fire in coming months and start cutting the rates in the first half of 2009.

Polish PMI heading south

Polish PMI dropped in September to 44.9 points marking its sixth consecutive decline, down from 45.6 recorded in August. A significant drop has been also recorded on a yearly basis. There were lower employment assessments (sub index dropped by 1.5 pctg points), lower inventories and decreasing new orders that weighted on the headline index. The breakdown of the headline PMI already follows the pattern typical for the economic slowdown.



Note that PMI sub indices are widely used in forecasting monthly economic indicators. Hence, a bit higher sub index referring to current industrial output conforms with our forecast of September industrial output of 6.3% y/y. On the other hand, lower employment points to a marked drop in corporate employment, which we forecast to drop to 3.9% y/y from 4.2% recorded in August.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.1	4.0
Inflation rate (%, avegage)	1.0	2.4	4.4	3.3
Current account (% of GDP, average)	-2.1	-4.5	-4.6	-5.3
Unemployment rate (end-of-year)	14.9	11.4	9.8	9.6
NBP repo rate (end-of-year)	4.00	5.00	6.00	5.25

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.8	4.4	4.0	3.8	3.8
Inflation rate (%, average)	4.3	4.7	3.8	3.5	3.3
NBP repo rate (end-of-quarter)	6.00	6.00	6.00	6.00	5.75

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

Fixed Income

Rates going down.

This week wasn't very interesting on the Polish fixed income market, however yields fell by some 10-15bp across the curve. Ministry of Finance revealed their inflation expectations at 4.4%, we think actual reading will come out even lower than that. ECB changed their tone significantly. Surprisingly, comments from MPC members are still in very hawkish tone, calling for immediate tightening. However we stick to our view, that hiking cycle has ended and we might see a rate cut already in Q1 next year. From that perspective there is still lots of value in front end of the curve. Position-wise we recommend stay received 9x12 and 2y, add to long 0413 position (however shorter maturities are also very attractive). We also expect curve to steepen and recommend paying 2y-10y spread.

RECOMMENDATION:

Stay receive. Add on upticks.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.061%	7/28/2008
26 Week T-bills	-	-	6.409%	9/15/2008
52 Week T-bills	10/13/2008	-	6.426%	9/15/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
5Y T-bond PS0413	11/5/2008	-	5.926%	10/1/2008
10Y T-bond DS1017	10/8/2008	-	6.054%	4/9/2008
20Y T-bond WS0429	12/9/2008	-	5.992%	9/10/2008

Money Market

Extremely cheap end of the reserve

Credit crunch continues

CPI forecast in line with expectations

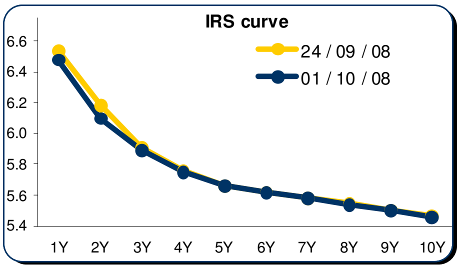
Extremely cheap end of the reserve settlement period, with the deposit in the central bank amounted to 9.5 billion pln. Almost whole last week polonia index was fluctuating nearby 4.5%. Situation has changed dramatically at the beginning of new reserve. Squared balance plus another wave of credit crunch hit the shortest rates severely, lifting shortest rates 2 figures from one day to another. Tomorrow's OMO will be crucial for polish liquidity as far as coming days are concerned. Not too many money bills should be offered just to send a signal, otherwise the demand should be low. If not, squeeze will persist.

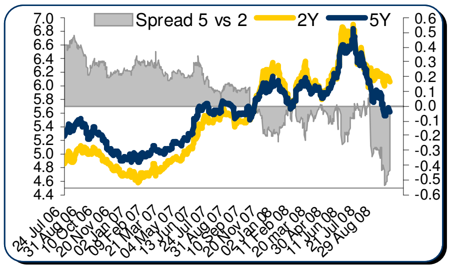
Liquidity problems have dominated all other activities. Hence, small turnover range trading was everything one could observe. CPI projection by the MinFin in line with expectations so looking forward for next figures.

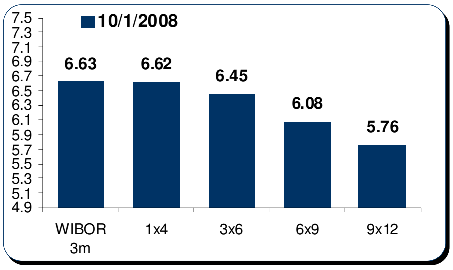
RECOMMENDATION:

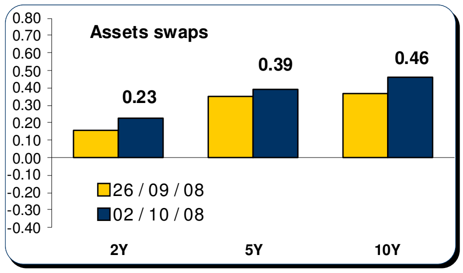
Pay 1y polonia near 5.8/5.85.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker/consolidating

Till last Thursday zloty has weaken from 3.3200 to 3.4200 against EUR (Tuesday peak), and is now consolidating in the relatively tight (for these stormy times) range 3.3750/3.4250. For USD/PLN it was a path from 2.2500 to 2.4600 (today's high), on the back of falling EUR/USD. In general market is much calmer then it was, in the previous weeks, with over night gaps being less dramatic.

Volatility very high

At first I wanted to write "volatility is extremely high" but I have decided to change it to "very high". As my imagination of extreme is constantly evaluating (especially taking USD/PLN run as an example). Both runs EUR/PLN and USD/PLN higher, 12.255 marking mid for 1MTH and 7.75% being mid for 1Y EUR/PLN, for USD/PLN it was respectively 20.5 1MTH and 15.75 1Y.

RECOMMENDATION:

SPOT

Play range

We believe that we should have a consolidation phase. We look to play the range 3.3700-3.4250. Liquidity has improved a bit, which also should have a smothering effect for EUR/PLN wild swings.

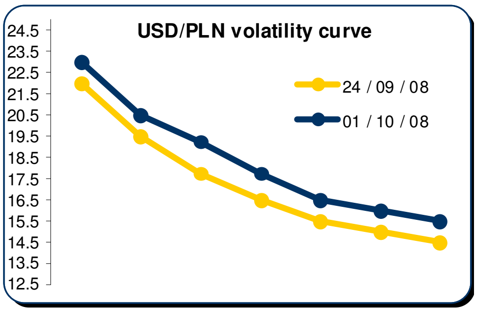
Main supports / resistances:
EUR/PLN: 3.3700 / 3.4250
USD/PLN: 2.3500 / 2.5000

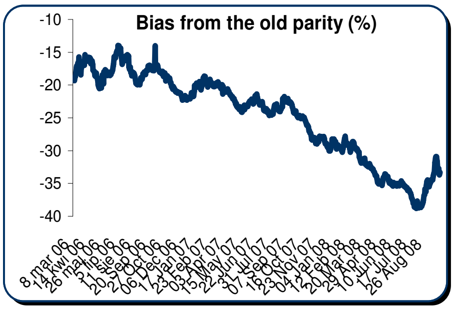
OPTIONS

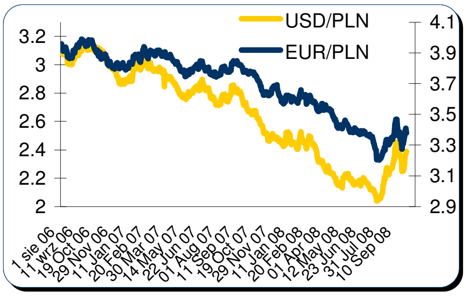
Short vega, short gamma

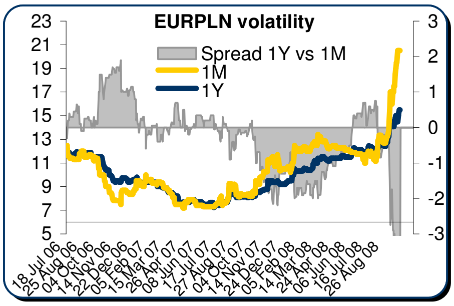
We think both runs EUR/PLN and USD/PLN are overpriced. Thus, we try to keep short vega and gamma in both currency pairs.

FX CHARTS


USD/PLN volatility curve
24 / 09 / 08
01 / 10 / 08


Bias from the old parity (%)


USD/PLN
EUR/PLN


EURPLN volatility
Spread 1Y vs 1M
1M
1Y

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
25/09/08	6.45%	6.59%	6.02%	6.52%	6.02%	6.55%
26/09/08	6.49%	6.59%	6.51%	6.52%	6.55%	6.54%
29/09/08	6.47%	6.59%	6.50%	6.53%	6.53%	6.54%
30/09/08	6.52%	6.63%	6.54%	6.56%	6.57%	6.59%
01/10/08	6.53%	6.67%	6.55%	6.59%	6.56%	6.62%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
25/09/08	6.59%	6.53%	6.21%	5.88%	6.09%
26/09/08	6.58%	6.52%	6.20%	5.89%	6.09%
29/09/08	6.58%	6.48%	6.17%	5.85%	6.05%
30/09/08	6.59%	6.44%	6.10%	5.79%	5.99%
01/10/08	6.62%	6.45%	6.08%	5.76%	5.96%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0709	IRS	PS0511	IRS	DS1017
25/09/08	6.55%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
26/09/08	6.54%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
29/09/08	6.54%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
30/09/08	6.59%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
01/10/08	6.62%	5.03%	5.56%	5.34%	5.70%	5.68%	5.70%	5.75%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	08/09/16	09/09/16	93.899	6.43%	800	1994	800
OK0710	08/08/06	10/07/25	88.390	6.47%	1800	3724	1830
PS0413	08/09/03	13/04/25	96.459	6.11%	2200	8986	2200
DS1017	08/07/09	17/10/25	91.480	6.50%	700	2461	705

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
25/09/08	20.50	17.00	15.50	14.50	1.50	1.50	0.30	0.35
26/09/08	20.50	17.75	16.00	15.00	1.50	1.50	0.30	0.35
29/09/08	20.50	17.75	16.50	15.25	1.50	1.50	0.30	0.35
30/09/08	20.50	17.75	16.50	15.50	1.50	1.50	0.30	0.35
01/10/08	20.50	17.75	16.50	15.50	1.50	1.50	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
25/09/08	2.2663	3.3340	-33.03%
26/09/08	2.2985	3.3575	-33.24%
29/09/08	2.3641	3.3949	-32.75%
30/09/08	2.3708	3.4083	-33.68%
01/10/08	2.3895	3.3775	-33.31%

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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