POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of May 22nd to May 29th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Retail sales	26 May	Apr	**0.6%**	-0.1%	-0.8%	Relatively poor performance of car sales compared with base effects from the last (later Easter) year may result in positive growth rate, despite negative (-1) difference in working days.
MPC decision	27 May	Apr	**3.75%**	3.75%	3.75%	Another tough decision to forecast. WIBOR rates speak for a rate cut whereas current mixed macroeconomic data encourage MPC members to wait for the new projection. Chances for a cut at 20-30%.
GDP growth	29 May	Q1	**1.1%**	1.0%	2.9%	Positive headline surprise, meager composition. Decelerating consumption (2% y/y), falling investment (-8% y/y) accompanied by negative government consumption, huge exports contribution (+3 pp.) and smaller build-up of stocks (contribution -1.8pp.).

In Focus / Macroeconomics

External rebalancing gathers pace

March was the second consecutive month with C/A surplus. After 915 mn EUR recorded last month it shrank to 75 mn EUR. As for the breakdown, further improvement in trade balance (to +77 mn EUR), decent inflow of EU funds and positive balance of services (+125 mn EUR) was recorded. The data fully confirm our scenario we sketched some months ago which assumed that economic slump and weaker zloty had encouraged domestic consumers and firms to considerably trim spending. As a consequence the spread between the growth rate of exports and imports widened to above 10 pctg pts.

We see this trend to continue in coming months (further improvement in trade balance, continuous inflow of EU funds, negligible dividend payments etc.) as consumers and firms retrench further. All this will most likely add more than 3 pctg. pts to the GDP growth in the coming quarters (see the wrap up of our research at the end of the document).

Poland is vividly adjusting to a more sustainable trade deficit level given the broader theme of reduction of external imbalances globally. The situation we witness now does not adhere to standard crisis scenarios (as in case of Hungary which got the IMFs conditional assistance) and, turning to monetary policy, definitely allows the MPC to cut further, addressing deteriorating business conditions in the background of improving stability of Poland as a small open economy.

I/O momentum improves, disinflation confirmed in PPI data

Industrial production fell in April by 12.4% y/y, led mainly by statistical effects: lower number of working days and later Easter. Seasonally adjusted indicator improved to -8% y/y (after -10.8% last month) suggesting slightly better momentum for manufacturing. Industrial output is going to stay under water in coming months (see also softer growth rate of wages and falling employment), although some tentative sings of stabilization in the German economy are likely to exert upward pressure on Polish exports (and manufacturing at the same time). The turnaround of industrial output may be a misleading green shot, though. What really matters for growth in 2009 is sloppy private consumption (unlikely to exceed 1.5% growth rate) and highly negative trend of investment – the so called internal demand is also what matters for monetary and fiscal policy (see the attached summary of the research note at the end of the document).

PPI recorded monthly fall for a second consecutive time confirming that disinflation process becomes more and more advanced. Next months are likely to bring further reductions in producer prices as labor costs diminish, PLN strengthens and spare capacities stay on high a level.

Market ignored the data. As for the MPC decision, our baseline scenario assumes a reduction in repo rate in June (along with inflation projection). After some comments from influential Slawinski, chances for a cut in May increased to about 30-40%. We still think the MPC has not properly recognized the mechanisms of the current slowdown. Negative internal demand is likely to put solid reins on price growth (within monetary policy horizon) and that is why we look for another rate cuts bringing repo rate to 3.0-3.25% this year.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	0.0	2.0
Inflation rate (%, average)	1.0	2.4	4.3	3.0	2.0
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-3	-2.5
Unemployment rate (end-of-year)	14.9	11.4	9.5	13.5	13.9
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.25	4.00

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	1.0	-1.0	-1.5	0.4
Inflation rate (%, average)	4.7	3.8	3.2	3.1	2.5	2.4
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.25	3.25

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

Fixed Income

Data, auction and Wibor rates

Last week we had mixed set of data, with CPI coming higher and IP plus PPI coming lower than expected. Market got also very positive surprise from C/A deficit which came surplus second time in the row. While it seems for the moment data are important only locally, and can trigger some positive or negative sentiment, the scope of the move is very limited to less than 10-15 bp. Auctions seems to attract constant interest and Ministry of Finance so far has no difficulties with funding deficit even despite worries about budget amendment and consensus about revenues falling much below planned. Cash market (as far as O/N is concerned) is moderate, despite temporary fears. What is most amazing is the continuing climbing of 3M and 6M Wibor rates, which are currently standing some 80bp above reference rate. Repo done by NBP gives premium to Wibors around 50 bp. Same levels were observed in November, December and January, the most severe period of local turmoil. While there are a lot of explanations given to the phenomena, we rather would like to focus on exploiting the possibilities. In our opinion the biggest value is in cash bonds especially up to 2y, and we favor the most 0711 either outright or in ASW, we also like receiving Polonia rates up to 6M, at the very moment we avoid receive positions in Wibor linked instruments as risk of “unfair” pricing can persist for some longer period of time. What we look for is ultimately 2 things. First is macro side, we think that the high point in CPI is already past, that is why we favor receive position. We think that cuts will be delivered in moderate pace, and talk about the end of the cycle is premature. We like cash instrument as eventually cash market is dependent on RPP decisions (either through repo facility or O/N rates which on average don’t exceed reference rate, so rate cut effect can be taken into calculations). We also think that some actions will be taken to make Wibor rates get again correlated with cash market and RPP decisions.

RECOMMENDATION:

Buy 0711 at current level, either in ASW (the cheapest bond to ASW apart from 0922), receive 6M Polonia at current rates (3.40%)

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	5/25/2009	-	5.055%	5/18/2009
2Y T-bond OK0711	6/3/2009	-	5.669%	5/13/2009
5Y T-bond PS0414	6/3/2009	-	6.039%	4/1/2009
10Y T-bond DS1019	6/10/2009	-	6.340%	5/20/2009
20Y T-bond WS0429	6/10/2009	-	6.340%	5/20/2009

Money Market

Relatively expensive week

6M repo tender debut

Mixed figures and comments

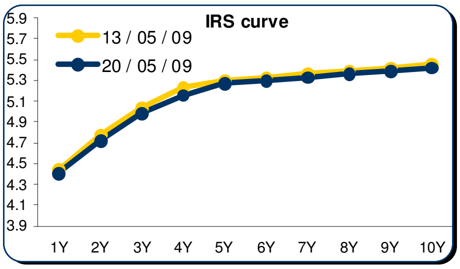
Relatively expensive week. The central bank offered again 16.5 billion pln in money bills, which resulted in around 1 billion shortage in the system. It probably was to smooth the impact of huge inflow from maturing bonds on Monday (12.5 billion pln May09 along with coupons), however it was just wishful thinking. Probably nothing will help the cheap end of the reserve requirement settlement period anyway. 6M repo with the central bank debut was successful; however we counted on a bit higher demand. Probably market split the total amount between 3 and 6M plus counts on a lower price in June for 6M tender.

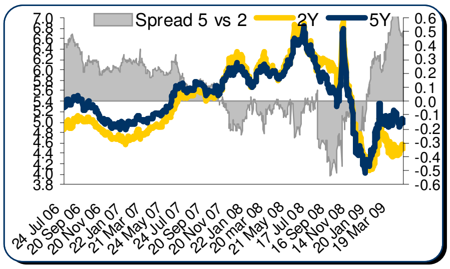
Mixed figures last week (CPI and wages quite bearish, and PPI and IO bullish) have not affected the market. Also mixed comments from the MPC side. We still see the biggest probability of another rates cut in June. As far is May is concerned we see the 30% chance of cut.

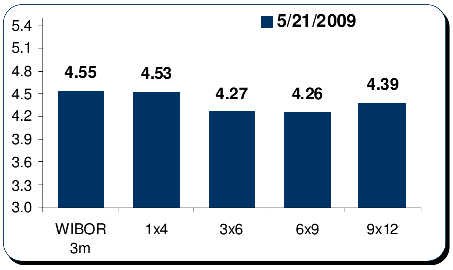
RECOMMENDATION:

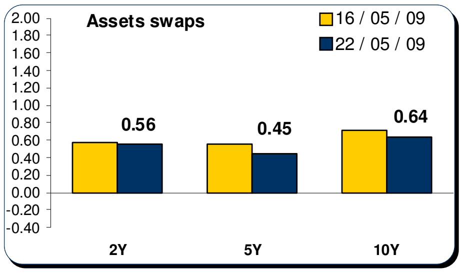
Sell 6M polonia at 3.4%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

This week zloty has opened at 4.4800 and strengthen down to 4.3300 on global equities rally. As sentiment had not remained so good we corrected to 4.4100 area.

Implied volatility untouched

Good global sentiment and EURPLN traded below 4.40 made new, this year, curve low, 1M was traded at 19.0 and 1Y at 17.0.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.2200 / 4.6000
USD/PLN: 3.1000 / 3.5000

Stay away

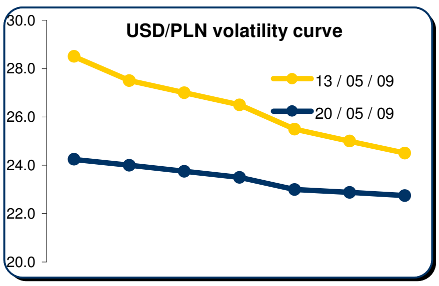
Zloty follows global equity play, we see high correlation with JPY crosses and US 10Y treasury bond. Although sentiment remains good we still see more risk on upside.
Breaking of 4.3250 on downside and 4.5200 on upside should generate signals for intensifying move.

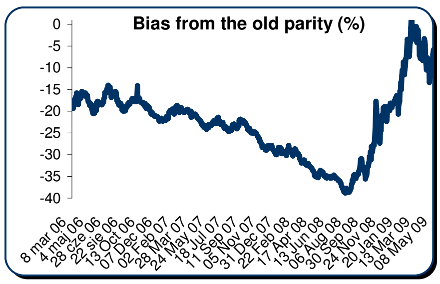
Short gamma

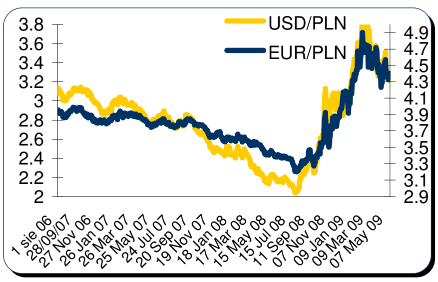
OPTIONS

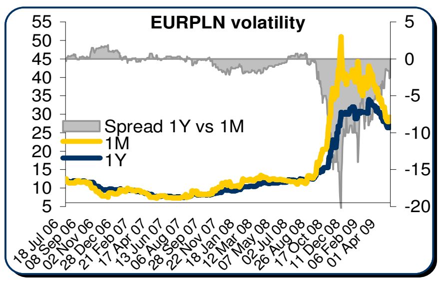
Vols looks a bit offered here, so we suggest wait for higher levels to entry short vega (20 vol for 1Y). Selling gamma, however, looks as good idea.
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.
Exporters may have some benefits from selling Risk Reversals as it is nearly highs (4.5 vols favour call).

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
14/05/09	4.37%	4.47%	4.48%	4.50%	4.70%	4.70%
15/05/09	4.38%	4.49%	4.49%	6.49%	4.74%	6.59%
18/05/09	4.40%	4.52%	4.53%	4.56%	4.80%	4.79%
19/05/09	4.41%	4.53%	4.54%	4.57%	4.86%	4.84%
20/05/09	4.42%	4.55%	4.55%	4.58%	4.82%	4.86%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
14/05/09	4.39%	4.26%	4.27%	4.43%	4.43%
15/05/09	4.43%	4.27%	4.29%	4.44%	4.44%
18/05/09	4.46%	4.31%	4.33%	4.49%	4.47%
19/05/09	4.45%	4.27%	4.29%	4.43%	4.46%
20/05/09	4.46%	4.27%	4.28%	4.45%	4.43%

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
14/05/09	4.70%	5.05%	4.83%	5.35%	5.37%	5.91%	5.51%	6.23%
15/05/09	6.59%	5.05%	4.78%	5.35%	5.32%	5.87%	5.46%	6.18%
18/05/09	4.79%	5.07%	4.77%	5.34%	5.31%	5.84%	5.44%	6.17%
19/05/09	4.84%	5.15%	4.76%	5.32%	5.33%	5.82%	5.48%	6.13%
20/05/09	4.86%	5.08%	4.72%	5.28%	5.27%	5.72%	5.42%	6.06%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/05/11	10/05/11	95.138	5.06%	800	1563	758
OK0711	09/05/13	11/07/25	88.602	5.67%	3150	5320	3313
PS0414	09/04/01	14/04/26	98.748	6.04%	1500	2427	1514
DS1017	09/04/08	19/10/25	94.460	6.22%	2500	4846	1820

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
14/05/09	28.00	27.00	25.75	24.75	3.75	5.25	1.25	1.25
15/05/09	28.00	27.00	25.75	24.75	3.75	5.25	1.25	1.25
18/05/09	27.00	26.00	25.25	24.75	3.75	5.25	1.25	1.25
19/05/09	26.00	24.50	24.00	23.75	3.75	5.25	1.25	1.25
20/05/09	24.00	23.50	23.00	22.75	3.50	5.25	1.25	1.25

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
14/05/09	3.2898	4.4757	-10.55%
15/05/09	3.2979	4.4762	-10.24%
18/05/09	3.3281	4.4773	-11.29%
19/05/09	3.2141	4.3821	-10.29%
20/05/09	3.1907	4.3573	-11.37%

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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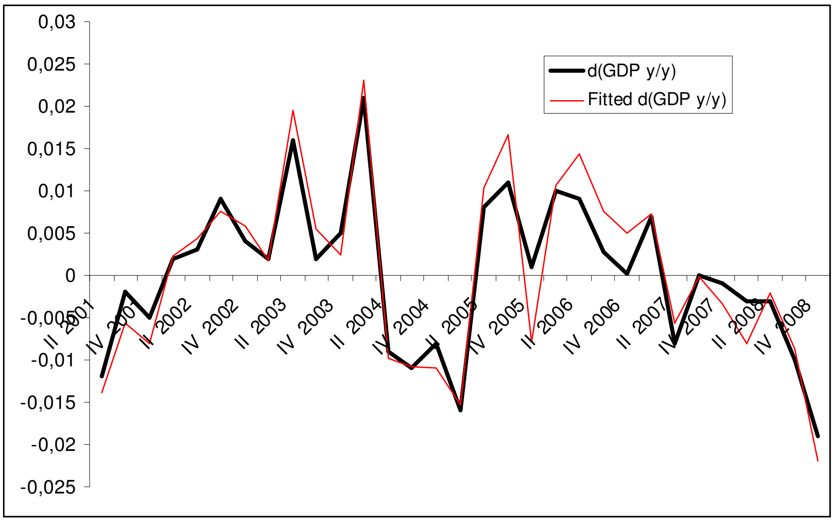
RESEARCH NOTE (summary of crucial findings)

GDP growth in 2009 – some interesting facts and analogies

In the piece below we wrap up our research note on GDP growth in 2009. In our opinion, both the headline figure and the composition may pose a surprise for the contemporary market consensus. The market prices in a substantial negative growth rate. In addition some dubious hypotheses have recently emerged on the possible ways of entering growth path, with some of them suggesting the sequence investment → consumption → exports. Apparently those claims are really hard to square with the data. We find that business cycles are still all alike, and thereby suggest quite a standard way out of recession in a small open economy: exports → consumption → investment.

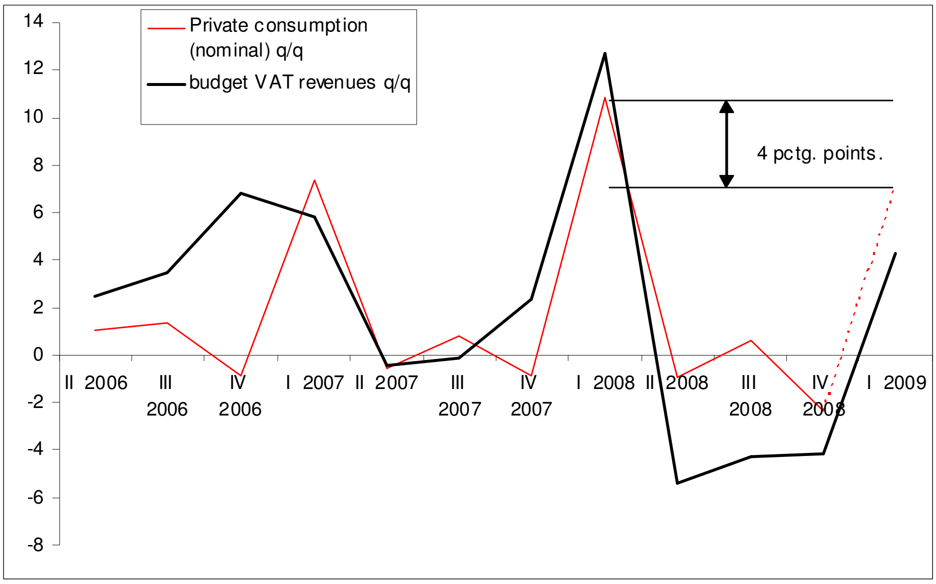
For a long time, we deal with short-term GDP forecasting by using simple econometric model based on *actual* readings of sold industrial output. At first sight, the approach seems naïve. There are many reasons, though, to think this indicator reflects broader trends in the economy – hence almost perfect fit of the model and stationary residuals (note the scale as the graph represents the difference in growth rates).

One-step model forecast vs actual reading

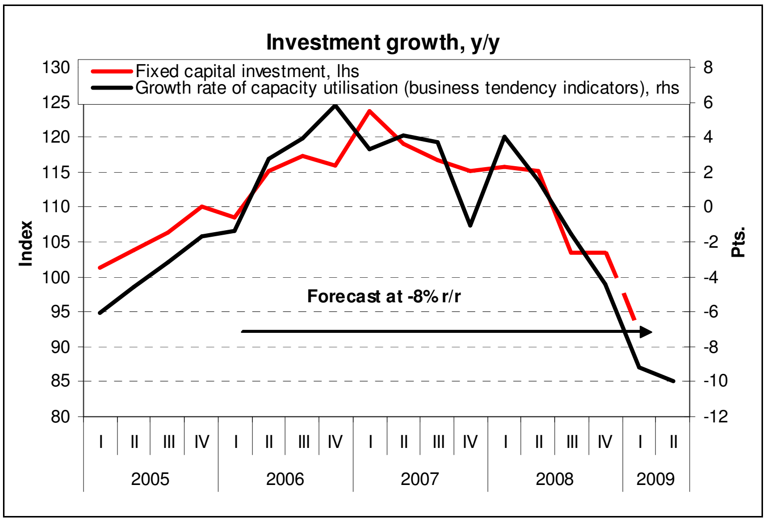


The forecast from the model implies Q1 GDP growth at about 1% y/y. Although the figure is really impressive when compared to regional peers, we do not take this at face value. Building a successful strategy demands a more thorough investigation of GDP components – it seems those are far less optimistic (see the analysis of the GDP breakdown below).

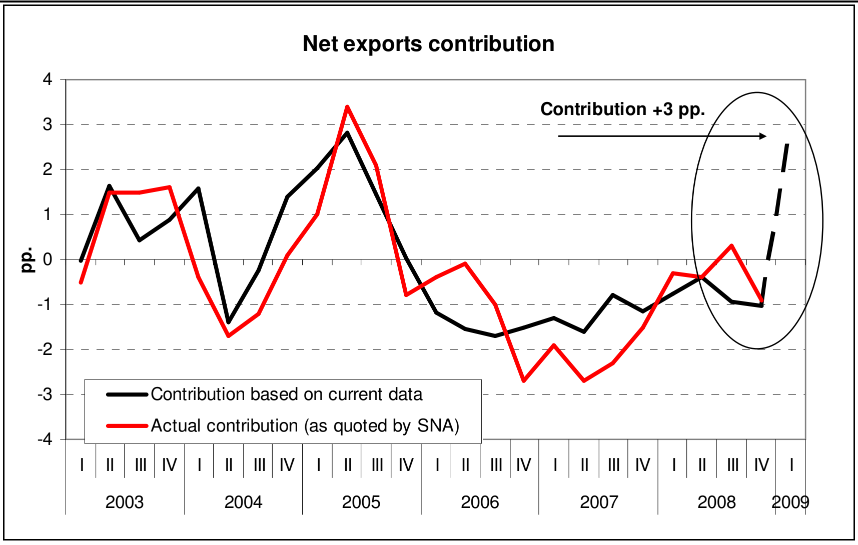
Consumption forecast. We forecast consumption on the basis of value added tax revenues. Although the correlation may be softened in times of the slowdown (shrinking tax base), the real growth rate of consumption may have fallen below 2% in Q1 (versus 5.2% in 2008 Q4).



Investment forecast. Cyclical over-investment, abrupt cuts of credit lines and worsened demand perspectives weigh on current growth rate of investment. We forecast it using econometric model based on investment goods and, separately, by looking at capacity utilization (from business tendency indicators). Both methods give similar fall of investment at about -8% y/y in Q1.



Net exports contribution. It was apparently the simplest element to forecast as it can be solely based on adding actual data. Owing to sharp deceleration of imports (weaker zloty, falling consumption) we witnessed a substantial improvement in trade and services balance which adds up to contribution of +3pp. Although the method does not give a perfect fit, it beautifully indicates changes in trends, and this is all we need right now.



Change in inventories. Business tendency indicators suggest the pace of inventory accumulation softened but remained positive. Such a finding conforms with stylized facts: relatively stable business activity indicators concerning output and strong deficiencies on the demand side. We expect inventories to deduct 1.5-1.8pp. from GDP growth.

Government expenditures. Initiated fiscal tightening probably tempered the growth rate of government consumption in the Q1 to about 0% y/y.

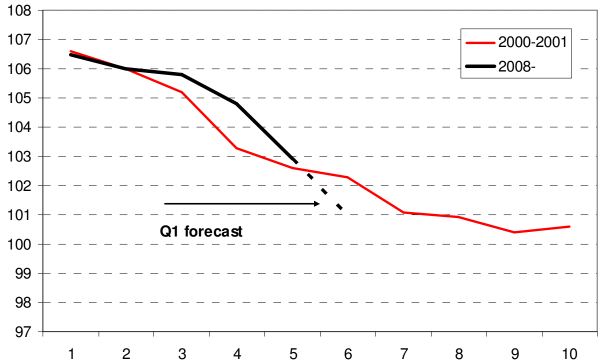
The above calculations add up to the GDP growth rate of around 0.8-1.3% in Q1, quite close to the point estimate of the econometric model based on sold industrial output.

Are the business cycles all alike? Comparisons with 2001-2002 slowdown and perspectives for 2009

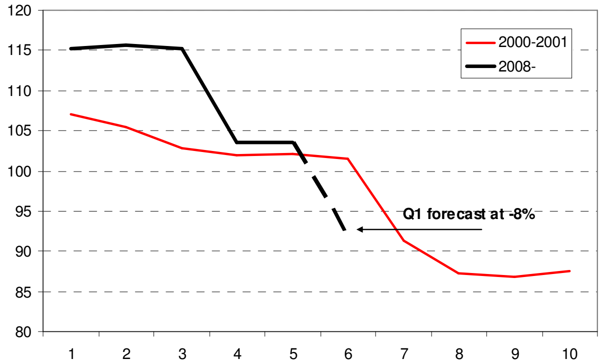
When we plot the current path of the slowdown supplemented by our forecasts for Q1 (we remind the reader we got those independently by nowcasting using current data) against the path of the slowdown in 2001-2002, we conclude that business cycles closely resemble one another. The similarities between the sequence of data leading into the recession are striking what leads us to conclude the exit mechanism may also work the same way. In particular we expect exports to recover first, followed by consumption and, finally, investment – not the other way round like some other analysts suggest.

In the following graphs, we plot the GDP components (annual growth rates) from peak to trough with 1 marking the last reading before the slowdown and 10 marking the trough. Let's dig into the GDP components.

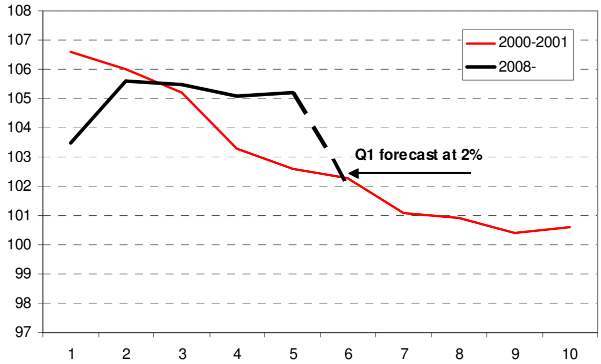
GDP, peak to trough



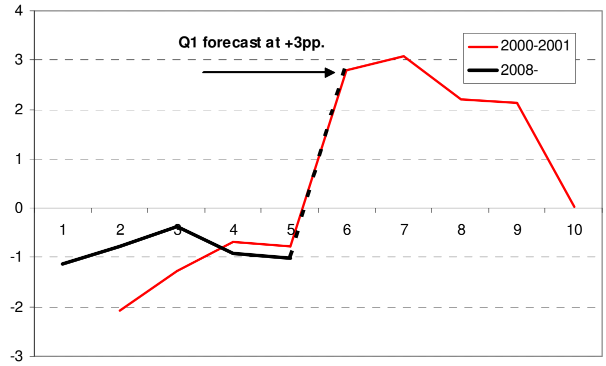
Investment, peak to trough



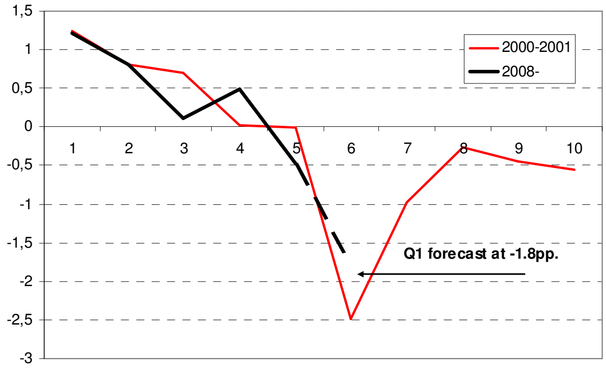
Consumption, peak to trough



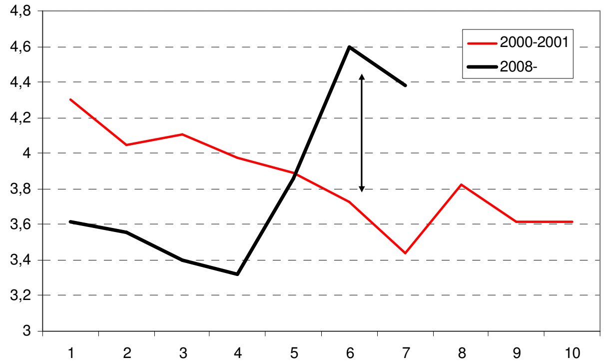
Net exports contribution, peak to trough



Change in inventories contribution, peak to trough



EUR/PLN, peak to trough



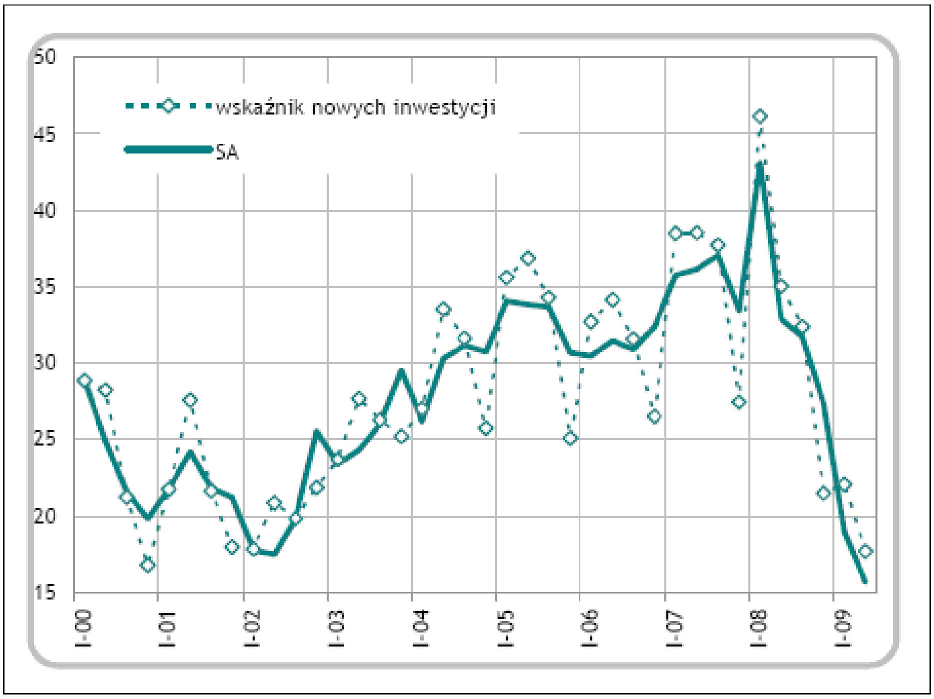
Consumption

For several months we have argued that consumption growth in 2009 may fall short of 2% (see the former research note and the relation between savings rate and consumption). The forecast finds more and more confirmation in hard data – especially improving trade balance (owing to sharp fall of imports).

On deeper contraction of employment, higher attractiveness of bank deposits, and series of hinders stemming from higher costs of debt service (sharp PLN depreciation), we decided to revise downward the growth rate of consumption this year. We would rather bet now on the interval 0.5-1.5%. It is easy to see a kind of a lag of consumption in the current cycle (see the peak to trough plot). It may be easily explained by relatively lax consumption credit policy of banks and perception failures (it seems that for long households regarded the current dip in activity as a short and temporary one). Both factors speak in favor of a more abrupt adjustment now which will especially weigh on 2009 consumption growth.

Investment

Investment outlook looks cloudy as well. It is really useful to look at business indicators concerning investment activity, prepared by the central bank (we apologize for Polish plot but there is no numerical data). The indicators fell below the levels recorded in 2001-2002. It suggests that not only can investment activity shrink more than in the previous cycle, but also that the slowdown may be quite prolonged (9 consecutive quarters of negative growth in the previous cycle).



Net exports

Apart from the influence on the households' net wealth which we discussed in one of the previous sections, softer exchange rate stimulates exports and limits imports (with the latter being the main force behind the improvement of the trade balance right now). Constant trade balance improvement may work towards decent net exports contribution during 2009 (even above +3pp.). Note also that additional boost to the trade balance improvement is given by the PLN depreciation, whereas former rebalancing took place within appreciation trend. The bottom line is that we may experience statistically decent 0% GDP growth with substantially negative growth rate of internal demand, quite disastrous scenario for the budget revenues.

Conclusions:

- Q1 GDP data (to be published May 29) may become a positive surprise for the financial markets (our forecast of about +1% y/y)
- Much softer consumption and investment lead straight to negative internal demand dynamics in 2009 and this, in turn, constitute disastrous scenario for the budget revenues (actual revenues may fall short of the plan by 40 bn PLN with state budget deficit headline figure approaching 40 bn PLN and general government deficit way above 5% of GDP)
- An abrupt external position rebalancing is likely to reduce risk related the foreign founding and, as a consequence, support Polish currency (we forecast EURPLN to fall to below 4.0 by the end of 2009).
- Finally, relatively high GDP growth (thought fuelled by net exports) may become an important beacon for foreign capital: at the very beginning portfolio investment, then foreign direct investment.

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