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FINANCIAL MARKETS DEPARTMENT

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WARSAW, JULY 9, 2009

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of July 10th to July 16th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A	Jul 14	May	**EUR 310 mn**	EUR 100 mn	EUR 710 mn	C/A surplus boosted by inflow of EU funds.
CPI Inflation	Jul 14	Jun	**3.9% y/y**	3.5% y/y	3.6% y/y	Higher food prices. Core inflation is to gradually decrease to 2.7% in June.
Corporate wages	Jul 16	Jun	**2.8% y/y**	2.6% y/y	3.8% y/y	Statistical high base effect. Underlying downward trend.
Employment	Jul 16	Jun	**-1.9% y/y**	-1.9% y/y	-1.7% y/y	Business survey data point to a modest improvement in labor market .

In Focus / Macroeconomics

2009 budget amendment sees sharp drop in budget revenues

According to the amended version of 2009 budget, revenues are expected to be PLN 30.1 bn lower than those set in the previous budget bill and amount to PLN 272.9 bn. Tax revenues may drop 46.6 bn below the previous target; VAT revenues may decrease by 24.5 bn, CIT and PIT revenues are expected to decrease by 10 bn and 6 bn, respectively. As announced two weeks ago, the revenue gap will be partially offset by higher dividend payments (+5.3 bn above the previous target). The resulting higher budget deficit (PLN 9bn) is to be founded predominantly domestically what – given the low overnight rates and bank's willingness to buy short-term bonds and bills – seems quite a realistic assumption.

The net borrowing needs have been newly estimated at PLN 48.5 bn, up from 37.8 set previously. Domestic funding is expected at 39.9 bn vs. 32.26 bn seen in the previous version of the budget. Offshore funding is estimated at the level of 8.6 bn vs. 5.5 bn seen previously. Note that net foreign holdings of polish government papers actually increased by 9.6bn since the beginning of 2009, beating so far the newly sketched plan. Moreover, by 1. July the government has funded 55% of its borrowing needs for the whole year.

The 2009 budget calculations have been based on pretty optimistic macro assumptions, though. It is evident that the FinMin expects the underlying trend in revenues to be left intact in H2 2009, which may prove to be an overly optimistic assumption as the main driver of budget revenues – domestic demand – is likely to deteriorate further this year.
Because of the aforementioned factors and the widely known phenomenon of deteriorating tax collectability in the contraction phase as well, we see some risk for the revenue side of the budget. One should note, however, that in terms of securing adequate funding, Polish fiscal policy proved to be both extremely flexible and effective this year – FinMin's successfully tracks the market sentiment and adjust bonds and bills supply according to the prevailing market conditions which results in reducing yield volatility and have started to attract some foreign portfolio capital.

Despite the gloomy outlook for the domestic demand and resulting lower budget revenues both this year and the next (we see general government deficit to top 6% of GDP), we do not think Poland will really witness a fiscal crisis scenario. First of all, the government may offset larger revenues shortfall fetching for additional dividend from PZU (up to PLN 10 bn). Secondly, the rising borrowing needs may be reduced thanks to accelerated privatization (up to PLN 30bn by the end of 2010). As for now, however, we do not really see the government willingness to tackle the rising deficit problem in a more systemic way (for example by increasing the VAT and PIT rates) as the political calendar (presidential elections in particular) is clearly working against any socially unpopular solutions. That is why we rather bet on usual process of reducing the deficit hinging completely on higher GDP growth in the years to come. This strategy may be, however, contested by investors and contribute to higher volatility on the bond market in Autumn.

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	3.4	1.8
Current account (% of GDP, average)	-2.1	-4.5	-5.3	0.2	-2.9
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.8	13.5
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.25	3.75

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	0.8	-0.2	-1.1	0.5
Inflation rate (%, average)	4.7	3.8	3.2	3.6	3.5	3.4
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

If our forecast CPI is correct …

The main event of last week was switch auction which triggered good interest at relatively neutral price. Afterwards two comments followed, one about CPI expectations from NBP official who is expecting low readings in next two months and other one from IMF who has upgraded GDP forecast for the 2010 for global economy. Thursday morning gave extra kick to the action with substantial PLN strengthening. Wibor rates are still in trend coming down 1 tic a day on average. We saw very good interest to buy bonds which help to tighten ASW even further. The highlight of next week will be CPI release which is expected to be at around 3.5% (our estimate 3.9%). With such a big difference in expectations we would be a payer of 2y IRS especially into the strength of the market, but we are very cautious because of 2 reasons. First - the period of low volatility makes even small moves (10-15 bp) look significant, and they can easily trigger stops, second - we still see potential in holding bonds in ASW, which definitely puts a cap on potential upside move in yields. Nevertheless, we would like to risk pay position into next week with tight stop loss – cause if our CPI forecast is correct …

RECOMMENDATION:

Recommendation: stay receive in OIS, hold ASW, pay 2y IRS into CPI

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	7/13/2009	-	4.455%	7/6/2009
2Y T-bond OK0112	8/5/2009	-	5.410%	6/3/2009
5Y T-bond PS0414	7/15/2009	-	5.783%	6/3/2009
10Y T-bond DS1019	9/9/2009	-	6.340%	5/20/2009
20Y T-bond WS0429	9/9/2009	-	6.340%	5/20/2009

Money Market

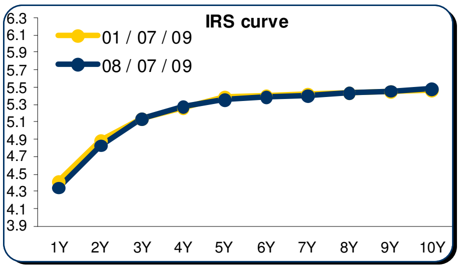
Central Bank try to continue absorb excess liquidity of banking sector. Last Friday they offered 36 billion PLN bills which would make the market square but the tender was under bided. Banks bought only 33 billion PLN. After the OMO short term rates dropped much below main rate and flow around 2,3-2,5 this week. This cheapness may continue to the end of this month and is reflected in the current OIS curve

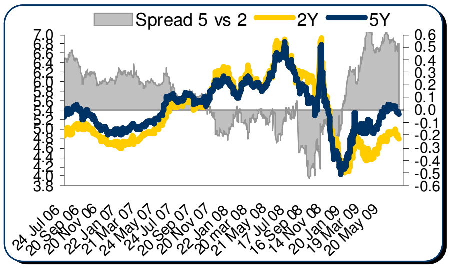
The average yield on Polish 52-week T-bill at primary tender down to 4,455% from 4,495%. Demand was 3,25 billion PLN and the Ministry sold all 1,2 billion papers from the offer.

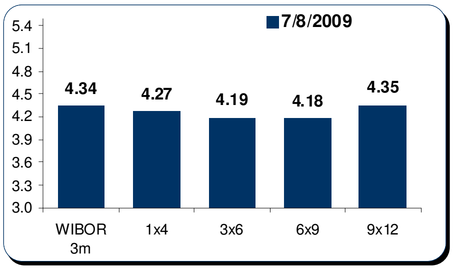
RECOMMENDATION:

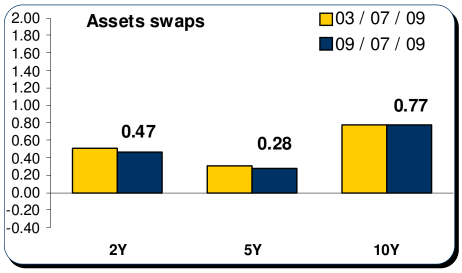
Offer short OIS up to 1M

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty consolidating

Today (Thursday), there was the rumor that, Scandinavian name is selling EUR to hedge the exposure of the Scandinavian road maker after the signature of the contract to design and construct the A1 motorway. But beside that the zloty is still a hostage to the global sentiment , and has spent the last week consolidating in the wide 4,34-4,46 range.

Implied volatility touch lower

Implied volatility is touch lower. There is a strong correlation between the spot and volatility. What makes us think that vanna is relatively cheap, in this spot driven market. We have seen both sides interes,t with US investment names being reported as mains buyers, and London names being among the sellers.

RECOMMENDATION:

SPOT

Play range

Main supports / resistances:
EUR/PLN: 4.3000 / 4.4500
USD/PLN: 3.0800 / 3.2000

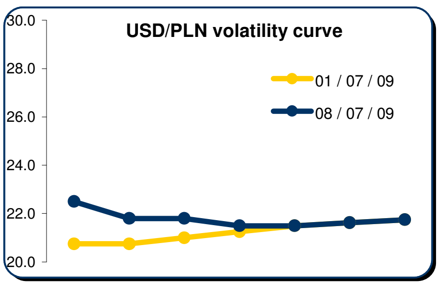
We don't think the market is strong enough to break out of the range. We prefer to play that range with the reasonably short stop loss.

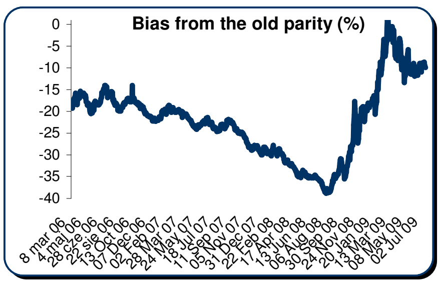
Buy 3m 25d RR EUR/PLN

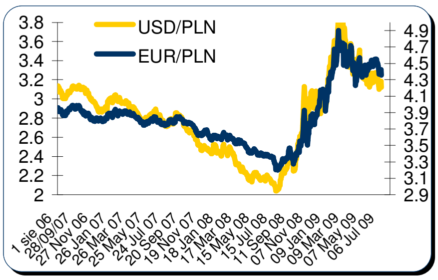
OPTIONS

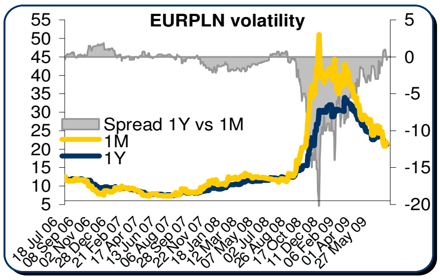
We are comfortable with being long in risk reversals in the mid of the curve. We think it's a relatively safe bet as the risk reversals are low , and the atm volatility is strongly correlated with spot .

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
02/07/09	4.29%	4.44%	4.48%	4.52%	4.65%	4.72%
03/07/09	4.22%	4.43%	4.46%	4.51%	4.62%	6.59%
06/07/09	4.30%	4.38%	4.38%	6.49%	4.55%	4.65%
07/07/09	4.28%	4.36%	4.50%	4.47%	4.67%	4.64%
08/07/09	4.24%	4.34%	4.40%	4.46%	4.61%	4.63%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
02/07/09	4.44%	4.34%	4.33%	4.49%	4.55%
03/07/09	4.40%	4.35%	4.36%	4.53%	4.53%
06/07/09	4.37%	4.25%	4.25%	4.41%	4.47%
07/07/09	4.36%	4.23%	4.22%	4.37%	4.47%
08/07/09	4.34%	4.22%	4.21%	4.36%	4.46%

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
02/07/09	4.72%	4.36%	4.89%	5.36%	5.38%	5.66%	5.47%	6.23%
03/07/09	6.59%	4.31%	4.85%	5.36%	5.36%	5.66%	5.46%	6.23%
06/07/09	4.65%	4.29%	4.88%	5.36%	5.35%	5.70%	5.43%	6.29%
07/07/09	4.64%	4.27%	4.86%	5.34%	5.38%	5.67%	5.48%	6.27%
08/07/09	4.63%	4.26%	4.83%	5.25%	5.36%	5.59%	5.48%	6.22%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/06/29	09/06/29	95.653	4.50%	1200	4663	1200
OK0112	09/07/01	12/01/25	87.362	5.41%	4500	4431	4006
PS0414	09/06/03	14/04/26	99.835	5.78%	1000	1614	971
DS1017	09/04/08	19/10/25	94.460	6.22%	2500	4846	1820

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
02/07/09	20.75	21.25	21.50	21.75	2.75	4.75	1.25	1.25
03/07/09	20.75	21.25	21.50	21.75	0.00	0.00	0.00	0.00
06/07/09	20.75	21.25	21.50	21.75	0.00	0.00	0.00	0.00
07/07/09	21.30	21.25	21.25	21.50	0.00	0.00	0.00	0.00
08/07/09	21.80	21.50	21.50	21.75	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
02/07/09	3.1013	4.3713	-8.80%
03/07/09	3.1236	4.3731	-9.56%
06/07/09	3.1483	4.3840	-8.69%
07/07/09	3.1298	4.3712	-9.29%
08/07/09	3.1852	4.4241	-9.56%

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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