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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of September 3rd to September 10th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
No relevant data releases						

In Focus / Macroeconomics

Shocking budget deficit figure for 2010?

Top Polish dailies, quoting sources close to the government circles, indicate that the government may set next year central budget deficit at the level much higher than PLN 40 bn vs. the previous deficit guestimates of at most 30 bn. Such a solution is to give the Ministry of Finance more flexibility in planning the 2011 (the election year) budget next year. Although it was widely expected that the next year general government deficit may top 6-7% of GDP, which would be justified by official FinMin's GDP growth forecast of 0.5% next year, no one has really expected that the government may attempt to drastically increase the headline figure i.e. the central budget deficit. Almost all analysts were rather betting on the government doing its creative accounting and shifting the spending away from the central budget as it was the case this year. We still expect the government to apply more gradualistic approach and ease the situation by issuing more mixed information, e.g. along with the shocking deficit figure it may indicate deficit course for next years by releasing the budget balancing strategy and stressing its determination in accomplishing the ambitious asset sales plan (privatization).

Note that passing a second safety threshold (55% of GDP) next year would have serious long term consequences for the fiscal policy. It would then mean the necessity of balancing the budget and announcing unpopular fiscal reforms in 2011 i.e. the election year. To avoid such a risk the government is to accelerate the privatization process, which enables funding higher deficit without incurring extra debts (lowering at the same time the risk of passing 55% threshold). Execution of quite an ambitious privatization plan (about PLN 25 bn in 2010), however, clearly hinges on the global sentiment and the course of the global economy.

As far as the short term perspectives for the budget are concerned they may have even improved a bit. Above all we note first signs of budget incomes stabilization (particularly VAT revenues). In our opinion Ministry of Finance should not have any serious problems with performing this year deficit. With the possibility of an agreement being reached between Ministry of Treasury and Eureko and PZU dividend pay-out from previous years profits, budget deficit may prove to be actually lower than planned..

This notwithstanding, fiscal issues (and a huge central budget deficit figure in particular) as well as those concerning PZU dividend pay-out have a strong potential to adversely influence financial markets (higher yields and weaker zloty) this autumn. This negative impact may well prove to be only temporary if the global economy continues to rebound. Global recovery will then result in further decrease of risk aversion and larger foreign capital influx into the Polish market in the mid term. One should also bear in mind that Polish fiscal deficit is mainly a cyclical story, higher growth (we see GDP growth at 2-3% in 2010) may help the budget (tax revenues in particular) by mid 2010.

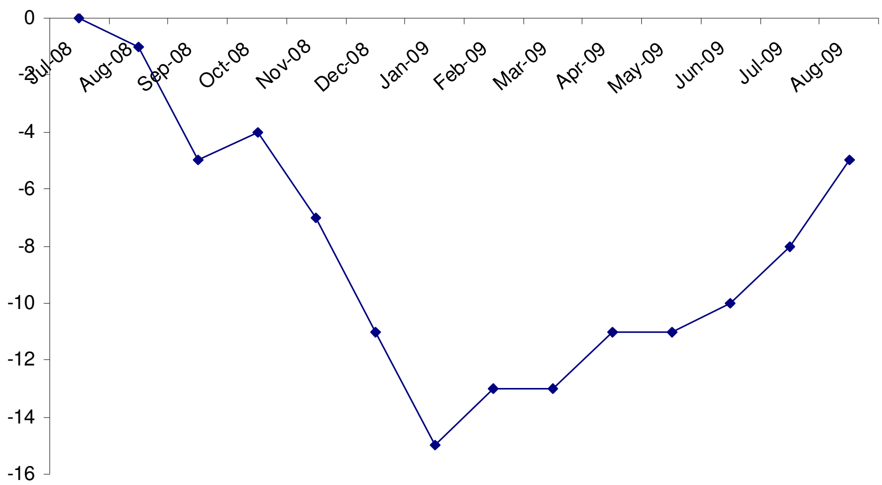
Strong PMI momentum continues

In August the logistics manager PMI index for Poland increased up to 48,2 points reaching its highest level since May 2008. This result is close to our expectations and far better than the consensus of analysts forecasts. The main driver behind the PMI index growth in August was an almost 3 point improvement in production subindex which, for the first time this year, passed the pivotal level of 50 points amounting to 51,9 points. Provider of the index states that further growth of the new orders-stock ratio will be the reason for a boost in next months (despite still existing employment limitations) while stock levels will be rebuilt. PMI data (mainly the component referring to the current production) favor our industrial production forecast for August – we expect an increase of the aggregate by 1,8% y/y (forecasts consensus is close to 0,3% y/y).

PMI dynamics along with the mounting discrepancies between analysts expectations and the actual macroeconomic data (consensus stood at 50,5 pts) and too persistent inflation rate (FinMin forecasts August inflation at 3,7% y/y) have a potential to generate rate hike expectation for next year.

Analyzing the formation process of market consensus itself (economists and strategists having in mind last year experiences are clearly negatively biased in their forecasts and scenarios, showing a disbelief in the efficiency of Fed policy as well as systematically underestimating short term momentum of the economy) we have an impression that Polish assets and currency, after a characteristic for September period of stronger volatility, may well strengthen in the mid term.

Index of positive and negative surprises



* Calculated as cumulated number of positive (actual figure for the real economy higher than consensus forecast, plus sign) and negative surprises (minus sign)

Finally, it is clear that an increase in PMI index for Poland is not a single case. In August the highest rises in the indices for China, Germany and the US economy since 2008 have been recorded. Considering that the elasticity of Polish economic growth with respect to the German growth exceeds unity, the buzz word for H2 2009 may well be a global recovery and global business cycle as opposed to the net exports and price competitiveness story explaining Polish growth phenomenon in the H1 2009.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	**1.1-1.5**	2.0-3.0
Inflation rate (%, average)	1.0	2.4	4.3	3.5	>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	**12.3**	**12.8**
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.50	4.00

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	0.8	1.1	**1.2**	**2.7**
Inflation rate (%, average)	4.7	3.8	3.2	3.7	3.5	3.6
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.50	3.50

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

Fixed Income

Are we pricing rate hikes ?

Last week was rather interesting on the FI market. After better then expected release of GDP figure we saw sharp move in the rates especially in the front end of the yield curve. 2y IRS traded as high as 5.15% (from 4.83% week before). Curve flattened further with 5y10y trading at -4. Bonds staid relatively expensive trading in the negative territories up to 5y. On Wednesday and Thursday we saw rates trading lower as some players judged move as to sharp, and saw 1y1y IRS (trading as high as 5.70%) pricing hikes to aggressively. 2y IRS traded at 5.00 as the low. Our opinion is that market is currently not pricing rate hikes scenario, move in rates was triggered by market positioning and pricing risk of MPC falling behind the curve. We still see risk of upside potential in yields especially in the front end of the curve. Economic releases will be pointing for further upswing in the economy, and additionally 3x6 FRA is fixing in December (there is a seasonal paten which shows some pressure on the cash rates).

TRADE IDEAS:

pay 1y3s at current level (4.40%)

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	9/8/2009	-	4.233%	9/1/2009
2Y T-bond OK0112	9/2/2009	-	5.130%	8/5/2009
5Y T-bond PS0414	9/2/2009	-	5.550%	8/12/2009
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

Extremely cheap end of the reserve

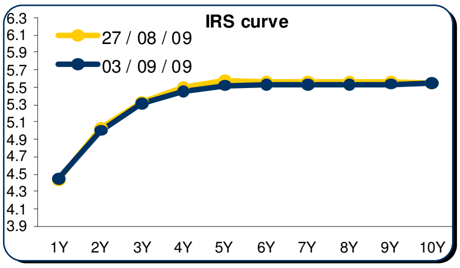
New calibration of the curve

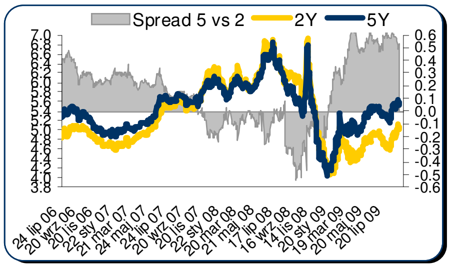
Last week of the reserve was extremely cheap, with the shortest rates slightly above 2% and growing deposit in the central bank. The start of the new reserve will be determined by today's open market operation. The supply will be around 40 billion pln. The question is whether the market buys it or not.
Nothing much for trading. The consensus as of today is for 50 bps hike in the middle of next year. No exact timing bets yet, just the main scenario calibration. Therefore longest oiss made around 20 bps up but without any significant turnover.

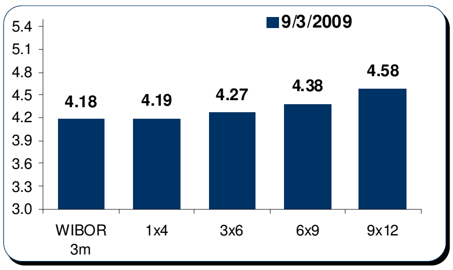
TRADE IDEAS:

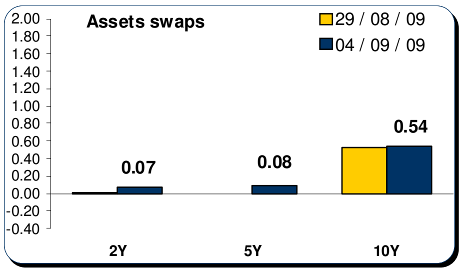
Offer 1Y polonia at 3,25%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty looking for trend

This week zloty has opened at 4.0900, touched low at 4.0740, weakened to 4.1850 just to get back to 4.1150. All zloty moves reflect global sentiment changes.

Implied volatility stays steady

Volatility curve waits for new zloty's trend, 1M moves in 13/15 range, while 1Y trades around 13-13.5.

SPOT

Main supports / resistances:
EUR/PLN: 4.0650 / 4.2700
USD/PLN: 2.8000 / 3.0600

TRADE IDEAS:

Play range/Sell upticks

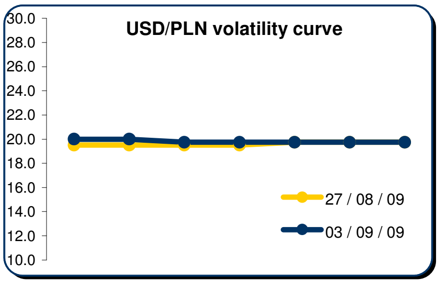
Zloty is trapped between 4.065 (Fibonacci) and 4.20 (EURPLN short entry level), driven by global sentiment waits for breaking out. Market looks slightly short, but stops are placed higher. With 2010 deficit bad number we play slightly long with 4.05 S/L level and 4.26/4.30 P/T/short entry.

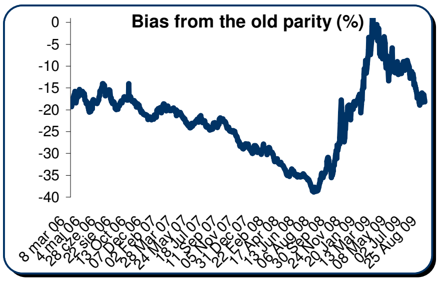
OPTIONS

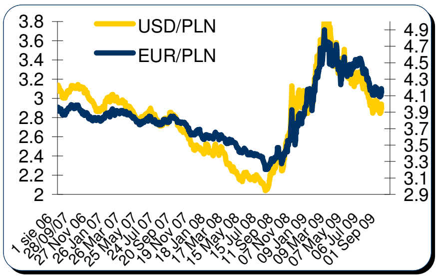
Stay away/Sell gamma

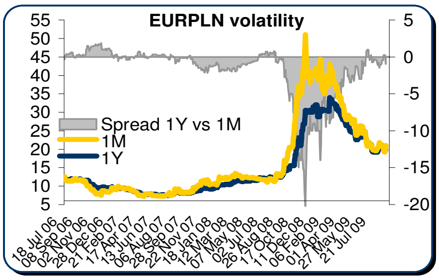
Curve is near this year low, we would like to see higher levels for short vega, but till zloty is trapped we still see chance for short gamma trade to be profitable.
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.

FX CHARTS


USD/PLN volatility curve
30.0
28.0
26.0
24.0
22.0
20.0
18.0
16.0
14.0
12.0
10.0
27 / 08 / 09
03 / 09 / 09


Bias from the old parity (%)
0
-5
-10
-15
-20
-25
-30
-35
-40


USD/PLN
EUR/PLN
3.8
3.6
3.4
3.2
3
2.8
2.6
2.4
2.2
2
4.9
4.7
4.5
4.3
4.1
3.9
3.7
3.5
3.3
3.1
2.9


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
55
50
45
40
35
30
25
20
15
10
5
5
0
-5
-10
-15
-20

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
28/08/09	4.01%	4.16%	4.20%	4.24%	4.32%	4.37%
31/08/09	4.04%	4.17%	4.17%	4.23%	4.35%	6.59%
01/09/09	4.11%	4.17%	4.19%	6.49%	4.33%	4.39%
02/09/09	3.99%	4.18%	4.21%	4.23%	4.40%	4.39%
03/09/09	4.07%	4.18%	4.21%	4.24%	4.39%	4.39%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
28/08/09	4.20%	4.23%	4.33%	4.53%	4.56%
31/08/09	4.22%	4.26%	4.37%	4.58%	4.60%
01/09/09	4.22%	4.28%	4.41%	4.61%	4.64%
02/09/09	4.24%	4.35%	4.47%	4.70%	4.68%
03/09/09	4.24%	4.32%	4.47%	4.69%	4.68%

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
28/08/09	4.37%	4.25%	5.08%	5.09%	5.60%	5.60%	5.55%	6.08%
31/08/09	6.59%	4.23%	5.12%	5.09%	5.63%	5.59%	5.57%	6.06%
01/09/09	4.39%	4.22%	5.11%	5.09%	5.60%	5.59%	5.54%	6.06%
02/09/09	4.39%	4.22%	5.06%	5.12%	5.59%	5.62%	5.55%	6.10%
03/09/09	4.39%	4.22%	5.00%	5.07%	5.52%	5.60%	5.54%	6.08%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/08/17	10/08/17	95.885	4.25%	1000	2213	835
OK0112	09/08/05	12/01/25	88.708	4.97%	4500	11232	4502
PS0414	09/08/12	14/04/26	100.759	5.55%	3500	4967	3500
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
28/08/09	19.25	19.30	19.50	19.50	2.75	4.25	1.00	1.10
31/08/09	19.25	19.30	19.50	19.50	0.00	0.00	0.00	0.00
01/09/09	19.25	19.30	19.50	19.50	0.00	0.00	0.00	0.00
02/09/09	21.00	20.00	20.00	20.00	0.00	0.00	0.00	0.00
03/09/09	20.00	19.75	19.75	19.75	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
28/08/09	2.8460	4.0854	-16.40%
31/08/09	2.8675	4.0998	-16.77%
01/09/09	2.8598	4.1025	-16.63%
02/09/09	2.9401	4.1823	-17.77%
03/09/09	2.8936	4.1387	-18.20%

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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