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FINANCIAL MARKETS DEPARTMENT

PAGES: 9

WARSAW, SEPTEMBER 10, 2009

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 10th to September 17th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A	11 Sep	Jul	**EUR -342 mn**	EUR +210 mn	EUR +459 mn	Negative surprise. We estimate exports to fall by 23.2% y/y. Import should decrease by 28.95 y/y. Lower influx of EU funds.
CPI Inflation	15 Sep	Aug	**3.6% y/y**	3.6% yy	3.6% y/y	Food prices to drop by 1.5% m/m. Core inflation seen at 2.9% y/y.
Employment	16 Sep	Aug	**-2.3% y/y**	-2.3% y/y	-2.2% y/y	Further signs of stabilization on the labor market.
Corporate wages	16 Sep	Aug	**3.9% y/y**	3.2% y/y	3.9% y/y	Higher wages in transports.
Industrial output	17 Sep	Aug	**1.8% y/y**	0.3% y/y	-4.6% y/y	Improving PMI and rising foreign demand.
PPI	17 Sep	Aug	**2.7% y/y**	2.7% y/y	3.0% y/y	Stronger zloty to offset higher raw materials prices.

In Focus / Macroeconomics

PLN 52.2 bn budget deficit for 2010

Polish debt market response to newly presented budget draft, with its headline deficit amounting to PLN 52.2 bn vs. market estimates of 40 bn, was reasonably negative. The yields rose across the board. As a good proof for the sentiment worsening may serve T-bills auction (yields higher by 20bp) as well as weak demand at 5Y bonds tender. The EURPLN response was quite limited at first as weaker dollar supported all EMEA currencies but to see a net effect of budget deficit news one should rather look at CZKPLN (PLN significantly underperformed the CZK).
All in all, rather limited initial market reaction to the news was due to the way the FinMin sold the story. Presenting the budget deficit in comparable terms to that of 2009 budget i.e. including balance of EU funds budget, may have caused more damage to the markets. **Including balance of EU funds deficit (PLN 15.3 bn) next year budget deficit rises up to 67.5 bn vs. revised 2009 estimates of less than 23 bn**. Note that FinMin increased this year estimated budget revenues by more than 4 bn as compared to the amended budget bill. This revision corresponds to some positive signs we have already noted in monthly budget figures in July. Please keep in mind though that the positive balance of EU funds will significantly boost (by at least 8 bn) 2009 central budget.

Revenues and spending: According to Minister Rostowski, the shape of 2010 budget was critically determined by political constraints (fear of a presidential veto and impossibility of cutting on fixed spending amounting to 75% of total spending) along with the necessity of restraining public debt below the level of 55% of GDP (government pushes for asset sales to set a limit for public debt). The Minister announced reduction in investment and private spending by almost 10% but those actions cannot change the big picture. 2010 fiscal policy is going to be very expansive and will support consumption.

Budget revenues in 2010 are estimated at PLN 245.5 bn, spending at no more than 297.7 bn. Tax and non-tax revenues in 2010 will nominally increase by 4.1% compared to 2009 (FinMin estimates a 1.2% y/y decrease in budget revenues for 2009). Revenues – GDP ratio in 2010 will amount to 17.9% vs. 17.6% in 2009 when typical for recession period lower tax collection occurred.
Tax revenues are said to be higher in 2010 by 6% compared to 2009 (FinMin estimates 2.3% y/y increase in tax revenues in 2009). Tax revenues – GDP ratio should rise from 15,7% up to 16,3% in 2010. VAT revenues should rise by 8.9%, from -4.2% y/y recorded in 2009. FinMin assumed very low revenues form dividends.
Those estimates base on the following macroeconomic assumptions: decrease in employment by 1.0%, increase in real GDP by 1.2%, 1.0% inflation rate, increase in real wages by 1.0%, increase in total consumption by 1.2% and average EURPLN of 3.85. These forecasts should be regarded as conservative; we see a significant risk that economic growth as well as inflation will top FinMin's estimates (which is definitely positive for budget income side).
Spending limit for 2010 is higher than planned in the amended budget bill for 2009 by 8.9%, which means 7.8% growth in real terms (expenditure growth is determined by the Defense Act, indexation of pension payments as well as an increase in infrastructure outlays). Expenditure – GDP ratio is to increase up to 21.8% from 20.4% in 2009, which should be seen as a clear evidence of expansive fiscal policy in 2010.

Funding: To fund budget deficit planned for 2010 (PLN 52.2 bn), EU funds budget deficit (PLN 15.3 bn), negative privatisation account balance (PLN 13.3 bn) as well as negative prefinancing balance (PLN 0.9 bn) the government has to borrow PLN 60.9 bn in domestic currency and PLN 20.8 bn in hard currencies.
As a result, net borrowing needs planned for 2010 will amount to 82.1 bn vs. 52.1 bn in 2009. Gross borrowing needs are estimated at nearly 204 bn vs. more than 163 bn in 2009. **Treasury bonds and bills issuance, most important for the debt market, should amount to 169 bn next year vs. estimated 137 bn in 2009**. It means that FinMin will be issuing securities worth of almost 15 bn monthly. Foreign issuance is to account for a bit more than 20 bn. For net borrowing needs see the tables below:

	2009	2010	2:1
	PLN mn	*PLN mn*	*%*
	1	2	3
Domestic funding	34 504.0	60 941.1	176.6
1. Securities	35 202.1	60 897.3	173.0

1.1. Market securities	33 782.9	59 333.2	175.6
a) T-bills	-2 952.2	8 938.6	
b) T-bonds	36 735.1	50 394.6	137.2
- floaters	-2 532.5	3 844.3	
- fixed	39 470.2	43 993.6	111.5
- indexed	-202.6	2 556.7	
1.2. Saving bonds	1 522.3	1 670.0	109.7
1.3. Non-market bonds	-103.1	-105.9	102.8
2. Loans	-444.6	43.8	
3. Other incomes and outgoings	15.7	0.0	0.0
4. Money on budgetary accounts	-269.2	0.0	0.0

	2009	2010	2:1
	PLN mn	*PLN mn*	*%*
	1	2	3
Foreign funding	9 331.7	20 797.2	222.9
1. Bonds	11 577.2	13 267.3	114.6
2. Credits received	6 424.3	7 979.2	124.2
3. Ecofund	-93.7		
4. Credits given	-1 048.9	-506.7	48.3
5. International organisations share	-352.3	-5.9	1.7
6. Other incomes and outgoings	-7 174.8	63.3	
6.1. Currency market flows	-7 238.5		
6.2. Prepayments			
6.3. Domestic inflows for foreign credits payoffs	63.7	63.3	99.4
6.4. Other			

Conclusions: <u>In the short term</u>, risk concerning strategy of both funding the deficit and escaping the public debt spiral by accelerating assets sales **should be reflected in higher yields on Polish papers**. Market participants are undoubtedly impressed by the bond supply next year and will carefully follow the on-going process of bonds issuing and privatisation. Even one single unsuccessful bond auction may be a disaster for the market. We think that FinMin has to accept higher yields for a while. Its buffer-stock behavior should be continued in order to avoid issuing bonds under even more unfavorable market conditions. We shouldn't therefore really count on smaller bond supply in Q4.

<u>Turning to mid term perspectives</u>, we see more support for the budget funding from rebounding economy and overliquidity in Polish banking sector (and to some extent to a newly announced one year REPO, of which terms are not known yet). The euro zone cheap money policy, which is to blame for low yield environment in the EUR may be working in the same direction. Low euro bond yields despite rising GSE (historically there is an adverse relation) make Polish yields relatively more attractive to foreign investors. Nevertheless, we cannot forget that government strategy means higher than ever risk of global business cycle affecting public finance. **Global sentiment worsening** (we highlight that **<u>this is not our base scenario</u>** but the chance of it happening could be quickly reflected in bonds prices) along with privatization fiasco will put Poland at risk of public debt trespassing 55% of GDP threshold. It would mean severe expenditure cuts and possible restraint of GDP dynamics in the next few years (not an optimistic scenario for all Polish assets).

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

It's just the beginning…

Most important event of the last week was the publication of planned budget deficit for next year. Even though the figure (52bio) is worse than previous market expectations, immediate reaction was quite limited. However demand on both t-bills and bonds auctions was definitely lower than it used to be previously, also yield 1y papers was higher by some 20bp than a week before. Some pressure on rates has been building up continuously and the yields went up by some 5-10bp during the week. Also bonds cheapened in ASW terms by some 10bp. NBP announced they are planning to introduce new 12-month repo facility to further improve banks liquidity. We don't know any details of that yet (when will it start, how often will it be done and at what price), however this should be positive for short maturities (up to 2y), we don't think it could have any impact on Wibors rates on the other hand. We stick to our view, see risks on the upside for the rates and the recent move seems to be just the beginning of the bigger move up in yields. In addition to our pay position in 1y3s (entry level at 4.40%, currently at 4.45%) we decided to open pay position in 5y at current level (5.65%)

TRADE IDEAS:

Stay pay 1y3s. Pay 5y at current level (5.65%).

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	9/14/2009	-	4.233%	9/7/2009
2Y T-bond OK0112	10/7/2009	-	5.130%	9/2/2009
5Y T-bond PS0414	10/7/2009	-	5.550%	9/9/2009
10Y T-bond DS1019	10/9/2009	-	6.340%	5/20/2009
20Y T-bond WS0429	9/23/2009	-	6.340%	5/20/2009

Money Market

Low short term interbank rates

Last Friday CB offered PLN 40.5 billion bills which would leave PLN 1 bn cash surplus in the system but the tender was under bidded. Banks bought only PLN 39.5 billion NBP bills. After the OMO short term rates dropped much below main rate and flow around 2.4-2.6 this week.
At the 3M repo on Tuesday demand was low – only 745 mn in comparison to 1.6 maturing.

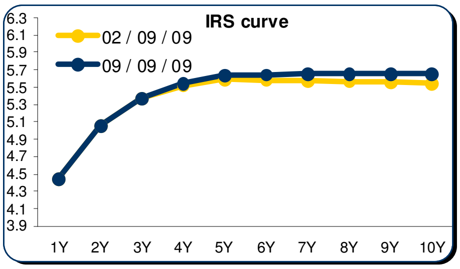
T-bill's yields up at the tender after deficit news

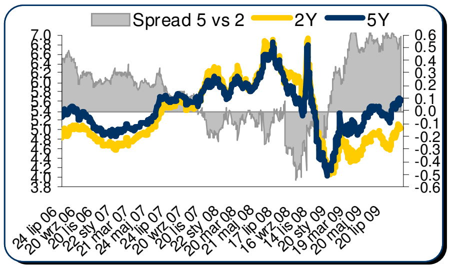
The average yield on Polish 52-week T-bills at primary tender up to 4.388% from 4.274%. Banks bidded PLN 1.54 bn and the Ministry sold 0.806 billion papers from the offer. Increase in yields was mainly caused by news from MinFin about deficit.

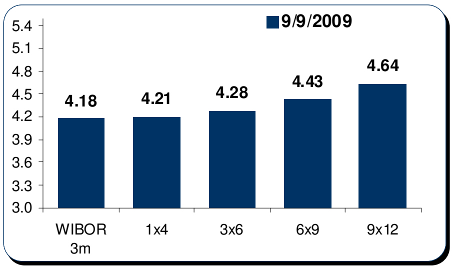
TRADE IDEAS:

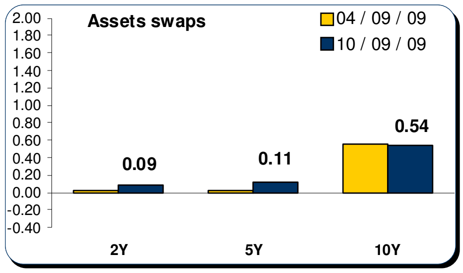
Offer short OIS up to 4M

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker but still in trend

This week zloty has opened at 4.0900, have been traded around 4.1000 and weakened toward 4.1900 despite risky assets performing quite well.

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 / 3.0000

TRADE IDEAS:

Buy on range bottom

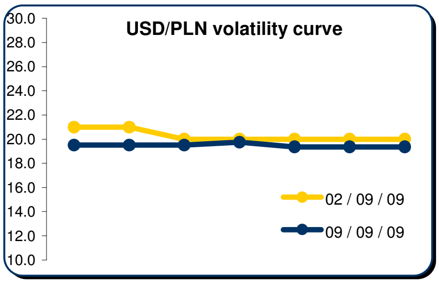
Zloty is trapped between 4.065 (Fibonacci) and 4.20 (EURPLN short entry level). Breaking of upside may be supported by bad budget data and outflows rumours. We like idea of being long at 4.1200.

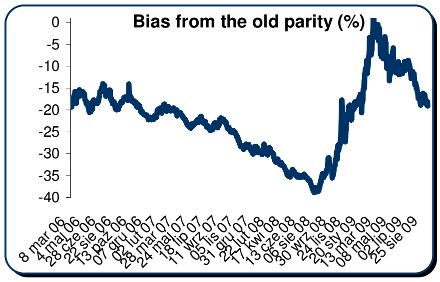
OPTIONS

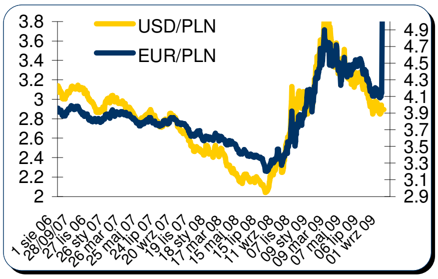
Buy RR

We see chance for higher vols/steepen curve if 4.20 broken. We suggest to buy 3M RR.

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
02 / 09 / 09
09 / 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
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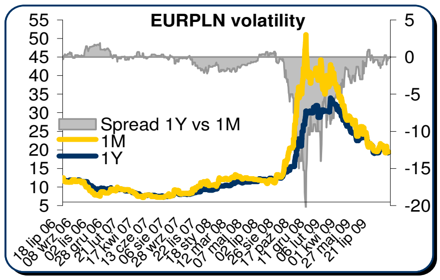
3.3
3.1
2.9


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
03/09/09	4.07%	4.17%	4.21%	4.23%	4.39%	4.39%
06/09/09	4.05%	4.17%	4.21%	4.23%	4.40%	6.59%
07/09/09	3.99%	4.17%	4.22%	6.49%	4.40%	4.39%
08/09/09	3.98%	4.16%	4.22%	4.24%	4.38%	4.39%
09/09/09	4.05%	4.18%	4.22%	4.23%	4.45%	4.39%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
03/09/09	4.24%	4.32%	4.47%	4.69%	4.68%
06/09/09	4.24%	4.34%	4.47%	4.70%	4.68%
07/09/09	4.21%	4.29%	4.43%	4.64%	4.62%
08/09/09	4.19%	4.27%	4.38%	4.58%	4.59%
09/09/09	4.21%	4.28%	4.39%	4.59%	4.63%

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
03/09/09	4.39%	4.22%	5.00%	5.08%	5.52%	5.62%	5.54%	6.10%
06/09/09	6.59%	4.25%	5.06%	5.08%	5.59%	5.62%	5.55%	6.10%
07/09/09	4.39%	4.37%	5.09%	5.12%	5.66%	5.70%	5.68%	6.16%
08/09/09	4.39%	4.41%	5.03%	5.14%	5.60%	5.75%	5.64%	6.20%
09/09/09	4.39%	4.40%	5.05%	5.14%	5.64%	5.75%	5.66%	6.20%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/09/08	10/09/07	95.752	4.39%	1000	1540	806
OK0112	09/08/05	12/01/25	88.708	4.97%	4500	11232	4502
PS0414	09/09/09	14/04/26	100.003	5.74%	2000	2159	1108
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
03/09/09	20.00	19.75	19.75	19.75	2.75	4.25	1.00	1.10
06/09/09	19.75	19.50	19.35	19.25	2.75	4.25	1.00	1.10
07/09/09	19.50	19.50	19.35	19.25	2.75	4.00	1.00	1.10
08/09/09	19.50	19.50	19.35	19.25	2.75	4.00	1.00	1.10
09/09/09	19.50	19.75	19.35	19.35	2.75	4.00	1.00	1.10

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
03/09/09	2.8936	4.1387	-18.20%
06/09/09	2.8936	5.1387	-18.36%
07/09/09	2.8936	6.1387	-18.65%
08/09/09	2.8936	7.1387	-18.96%
09/09/09	2.8936	8.1387	-18.02%

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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