



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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FIXED INCOME

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PREVIEW: The week of August 22nd to August 28th

Indicator	Date of release	Period	BRE fore-cast	Consensus	Last	Comment
Retail sales	Aug 26	Jul	13.9%	14.5%	14.2%	One more working day on annual basis. Business tendency indicators softer on monthly and annual basis.
MPC decision	Aug 27	-	6.00%	6.00%	6.00%	The surprise from the real sphere, along with recent comments of the key members, suggests there will be no majority to hike. Owing to cloudier real sphere perspectives, the more dovish wing may soon opt for lower rates. We see rates on hold in the present cycle; rate cuts possible in Q2 2009, preceded already by the yield curve.

In Focus / Macroeconomics

Economy slowing faster than expected

Industrial output rose in July by a meager 5.6% y/y, substantially below market expectations and previous reading of 7.3%; seasonally adjusted figure amounted to 4.4% y/y. The reading confirms fully our scenario of a looming slowdown. The data on wages and employment point to the same direction. Although both readings came out above the market consensus (at 11.6% y/y and 4.8% y/y respectively), the monthly variation of the growth rates lag behind the dynamics recorded in the corresponding period of the previous year.

This time, the Polish economy seems to be hit by a slowing Europe to a much greater extent as compared to the previous economic cycles. In addition, rising wages make the situation of the Polish producers worse – in the wake of easing demand producers are less likely to pass on the costs to foreign and domestic consumers. July data, with annual PPI and core PPI rate dropping to 2.3% and 1.0% respectively seem to confirm this hypothesis. On this front, lower commodity prices and strong zloty are to tame inflationary pressures in coming months when growth flatters.

Turning to the short-term forecasts, we expect both the industrial output and PPI to trend downwards in the months to come. Taking into consideration the negative difference of 2 working days in August, a very probable estimate points to a negative output in annual terms then (it will definitely propel the expectations for rate cuts).

The scenario of a cyclical slowdown and easing inflationary pressures seem to dominate the minds of financial markets participants at the moment. We share this view trying at the same time to decipher the timing of eventual rate cuts. By the way, the unfortunate comments made by a dovish Owsiak from the MPC who claimed that the Committee would cut the rates no sooner than in first quarter of 2009 has been already challenged by the markets today.

A fairly strong confirmation to our hypothesis came along with the publication of MPC “Minutes” on late Thursday. They explicitly show that the majority of members were opposing rate hikes citing strong zloty appreciation and expected economic slowdown accompanied by the effects of recent hikes. They also point to the fact that too aggressive monetary policy may lead to stronger currency and lower exports (much the same rhetoric as the one followed by the Czech National Bank; the only one exception is that they have already lowered interest rates...) and rising tension in the balance of payments. Those factors made the majority of the MPC to adopt a wait-and-see stance (likely to have been tilted since then towards more loose monetary policy).

MEDIUM-TERM FORECASTS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.1↓	4.0
Inflation rate (% average)	1.0	2.4	4.5	3.7
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 (%)	5.3	4.7	4.0	3.8	3.8
Inflation rate (% average)	4.3	4.7↓	4.0↓	3.9	3.7
NBP repo rate (end-of-quarter)	6.00	6.00	6.00	6.00	5.75↓

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

Fixed Income

The rally continues

So the yields fell down by another 15-20bp this week and we're some 100bp lower than the highs we observed six weeks ago. It seems that it is right time for the correction in the downside trend. Even though recent economic data release support our view of oncoming slowdown and vanishing chances for further rate hikes this year, we decided to reduce our receive positions, especially in the 5y sector. We see curve steepening in the near future, so we see biggest value in the front of the curve - 1y and 2y. Wibors still have some room to ease, and from that perspective 9x12 above main rate seems attractive to receive. If next month CPI figure doesn't exceed 5% and industrial production continues to slow, market should price in next year's rate cuts more aggressively.

RECOMMENDATION:

Close long 0413 position. Stay receive in the front end, add on upticks.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.061%	4/14/2008
26 Week T-bills	-	-	6.220%	4/14/2008
52 Week T-bills	9/8/2008	-	6.490%	8/18/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
5Y T-bond PS0413	9/3/2008	-	6.155%	5/7/2008
10Y T-bond DS1017	10/8/2008	-	6.054%	4/9/2008
20Y T-bond WS0922	9/12/2008	-	6.080%	5/14/2008

Money Market

Turbulences on cash

Rates cuts are now on

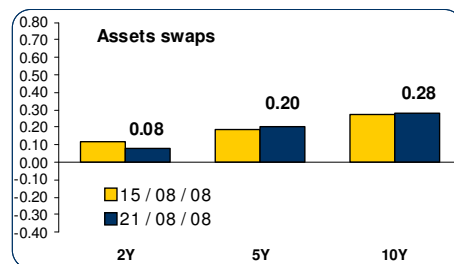
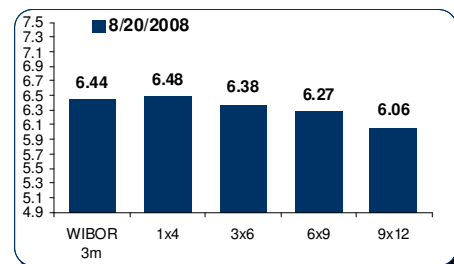
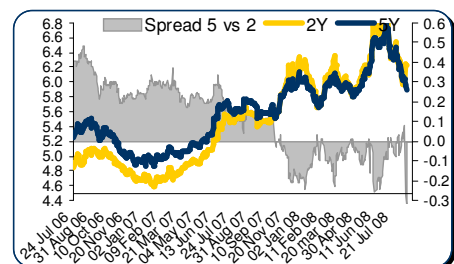
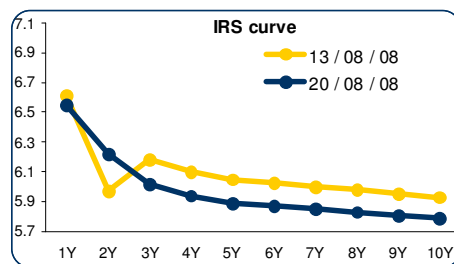
Some turbulence on cash depended most probably on the deposit rollovers that MinFin makes for short periods. Probably information they had given to the central bank before last OMO did not materialized in reality. Hence, cost of carry was around 50 bps above the main market rate. It should be back to normal tomorrow.

High wages (11.6%) completely ignored. Lower IO (5.6% vs 7.8% expected) triggered rates cuts expectations. Situation is fresh so all we can say is that PLN OIS curve discounts two 25 bps cuts during the first half of next year. Now we have to answer the question what is the probability of this scenario.

RECOMMENDATION:

Pay 6M Polonia

FIXED INCOME & MONEY MARKET CHARTS



Foreign Exchange

Zloty weaker

During last week the zloty has continued to weaken, EUR/PLN turned back slightly above our previous resistance at 3.3456 and settled near 3.3170 level. USD/PLN has followed the same pattern breaking our resistance placed at 2.2450 and changed its direction at 2.2752 levelling off today near 2.2450.

Volatility curve slightly higher

EUR/PLN 1M volatility has declined recently by 0.30 to 6.90, while 1Y remained unchanged at 6.40. USD/PLN 1M has dropped from 13.25 last Thursday to 12.75 with 1Y being stable at 12.50.

RECOMMENDATION:

SPOT

Main supports / resistances:

EUR/PLN: 3.2800 / 3.3500

USD/PLN: 2.1900/ 2.2750

long PLN positions against USD

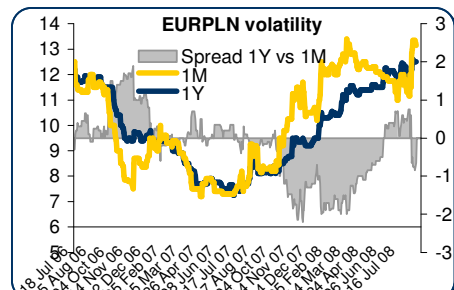
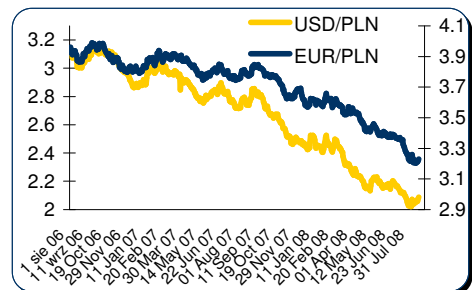
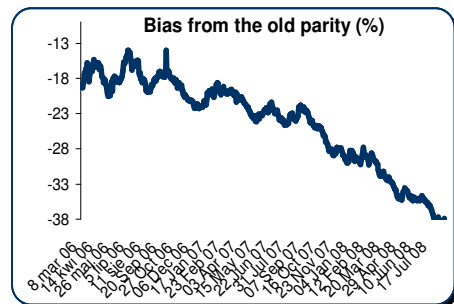
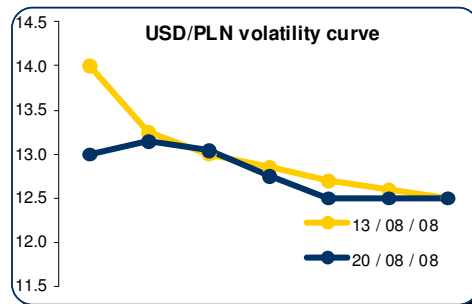
EUR/USD is a key driver for the C4 at the moment. We expect the pull back of the current USD rally. If we are right, the PLN should get stronger, and the USD/PLN should be the main beneficiary of this move. We looking for pull back to 2,1800 and set s/l at 2,2700.

Hold short vega and gamma

OPTIONS

Keep short vega and gamma anticipating probable volatility curve mean-reverting.

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
13/08/08	6.39%	6.36%	6.49%	6.49%	6.58%	6.59%
14/08/08	6.45%	6.43%	6.53%	6.53%	6.64%	6.65%
18/08/08	6.30%	6.43%	6.35%	6.53%	6.34%	6.65%
19/08/08	6.43%	6.44%	6.36%	6.54%	6.32%	6.64%
20/08/08	6.32%	6.44%	6.35%	6.54%	6.29%	6.64%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
13/08/08	6.54%	6.49%	6.40%	6.17%	6.35%
14/08/08	6.53%	6.48%	6.37%	6.17%	6.31%
18/08/08	6.53%	6.48%	6.38%	6.19%	6.33%
19/08/08	6.50%	6.45%	6.35%	6.13%	6.29%
20/08/08	6.51%	6.48%	6.39%	6.18%	6.33%

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
13/08/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
14/08/08	6.65%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
18/08/08	6.65%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
19/08/08	6.64%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
20/08/08	6.64%	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	08/08/18	08/08/18	93.842	6.49%	500	2330	500
OK0710	08/08/06	10/07/25	88.390	6.47%	1800	3724	1830
PS0413	08/04/07	13/04/25	96.211	6.16%	1800	3129	1800
DS1017	08/07/09	17/10/25	91.480	6.50%	700	2461	705

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
13/08/08	13.25	12.85	12.70	12.50	1.00	1.00	0.30	0.35
14/08/08	13.25	12.85	12.70	12.50	1.00	1.00	0.30	0.35
18/08/08	13.35	13.00	12.70	12.50	1.25	1.00	0.30	0.35
19/08/08	13.25	12.85	12.60	12.50	1.25	1.00	0.30	0.35
20/08/08	13.15	12.75	12.50	12.50	1.00	1.00	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
13/08/08	2.0509	3.2026	-38.64%
14/08/08	2.0665	3.2170	-38.29%
18/08/08	2.0600	3.2100	-38.45%
19/08/08	2.0777	3.2192	-38.14%
20/08/08	2.0875	3.2305	-37.89%

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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