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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

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# POLAND WEEKLY REVIEW

## MACROECONOMICS AND FINANCIAL MARKETS



### PREVIEW: The week of October 17th to October 23th

| Indicator | Date of release | Period | BRE forecast | Consen-sus | Last | Comment |
|---|---|---|---|---|---|---|
| **I/O y/y** | **Oct 17** | Sep | **6.3%** | 5.6% | -3.7% | Two days more on annual basis. Business tendency indicators concerning order books still at the level similar to the last month. Higher (than consensus) reading supported by auto production, as reported by Samar, +91.2% m/m. |
| **PPI y/y** | **Oct 17** | Sep | **2.4%** | 2.1% | 2.0% | Slightly lower price expectations of producers, but (at the same time) weaker zloty meaning higher commodity prices in terms of PLN. |
| **Core "net" inflation y/y** | **Oct 21** | Sep | **4.3%** | 4.2% | 4.0% | We updated our assessment after the CPI figures and relatively high growth of prices of education and wearing apparel. New measure excl. energy and food at 2.9%. |
| **Retail sales y/y** | **Oct 23** | Sep | **9.9%** | 11.7% | 7.7% | 2 working days more on monthly basis, no surprises with no-trading days. Business indicators softer on monthly and annual terms. Lower dynamics of food and auto sales likely to be continued. |

# In Focus / Macroeconomics

## A series of “inflationary” data is (eventually) not going to prevent the MPC from easing

The overture began with the publication of CPI inflation which came out above the consensus and ended with elevated growth rate of wages. The number of autos which were turned out during September days surprised to the upside, adding to fears that also industrial output may come higher than generally expected. What is the impact of the data on monetary policy? Rather negligible, as the MPC is debating economic slowdown and financial markets turmoil.

After downward surprises in the region (lower food prices in Czech Republic, lower headline CPI in Hungary) Polish price growth seems to be the odd one out. And indeed it is as the divergence between our forecast (4.3% y/y) and the official figure (4.5% y/y) results form idiosyncratic behavior of prices in education which surprised substantially on the upside. We also saw a more significant monthly increase in energy prices and wearing apparel, the latter likely to be driven by unfavorable developments on the FX market. Other components of the basket came largely in line with our expectations.

Headline CPI figures are set to gradually decrease, owing much to calmer commodity markets – outright declines of oil prices and stabilization of foods. However, core inflation is to stay elevated for some time (our calculations show that core net inflation rose in September to 4.3% whereas the new measure stripping CPI form energy and food accelerated to 2.9%) till the expected slowdown of economic activity exerts the opposite pressure on quoted prices.

As for the labor market we saw a further contraction of employment growth which eased to 4.1% in September from 4.2% a month ago. Despite this fact, the growth of wages remained at fairly elevated level 10.9%. However, it was inflated by the higher number of working days (+2 y/y) and short-term changes in economic activity – stripping those leaves the dynamics in a gradually slowing trend. The softness of the labor market is to become even more visible in coming months (watch the October wage figure, according to our estimates, falling below 9% y/y).

Recent comments given by the MPC members indicate they may have already seen the inflation projection and begin to spread the news. For some weeks we’ve been indicating that, fundamentally, inflation path will be lower – now comes the confirmation. As for the GDP growth path, it may look cloudy as well given the ongoing liquidity squeeze and demand deficiencies. The MPC seem to have “natural restraints” to rely solely on the projection. Thus they seem to frenetically look for the confirmation of the gloomy forecast in the data. This month – they are misleading (e.g. difference of working days), next month – they will constitute an excellent benchmark for economic activity (no working days effects on annual basis). Faltering business activity indicators are going to find conformation in the real data in October. Hence, the long-awaited slowdown will materialize in terms “accepted” by the MPC members.

To conclude, we think that inflation projection is a gate to lower rates generally but it is the real sphere data and the zloty volatility what determines the exact timing of the monetary losing. The developments in Hungary are to restrain the MPC from any abrupt moves on rates. Nevertheless we attach 50% probability that the rates will be brought down by the end of the year; 2009 is likely to see a consecutive easing of at least 100 bp.

***MEDIUM-TERM FORECATS***

| Indicator | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|
| GDP y/y (%) | 6.1 | 6.5 | 5.1 | 3.5 |
| Inflation rate (%, avegage) | 1.0 | 2.4 | 4.4 | 3.2 |
| Current account (% of GDP, average) | -2.1 | -4.5 | -4.6 | -5.3 |
| Unemployment rate (end-of-year) | 14.9 | 11.4 | 9.4 | 9.6 |
| NBP repo rate (end-of-year) | 4.00 | 5.00 | 6.00 | 5.00 |

| Indicator | 2008 | | | 2009 | |
|---|---|---|---|---|---|
| | Q2 | Q3 | Q4 | Q1 | Q2 |
| GDP y/y (%) | 5.8 | 4.4 | 4.0 | 3.5 | 3.5 |
| Inflation rate (%, average) | 4.3 | 4.7 | 3.8 | 3.5 | 3.3 |
| NBP repo rate (end-of-quarter) | 6.00 | 6.00 | 6.00 | 5.75 | 5.25 |

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

## Fixed Income

*No improvement.*

The market hasn't improved during this week at all. It even got worse - liquidity vanished almost completely, yields went up by some 20bp, asset swap spreads widened again, reaching new record levels. It seems that current situation is quite likely to persist for some time. In this environment it's doesn't make much sense to build significant positions based on fundamentals, so we prefer to stay flat in terms of risk. As opportunities created in times of such abnormalities do not straighten quickly, we think there will be time to start building positions. As for now we prefer our cautious observers' stance.

***RECOMMENDATION:***

Keep reduced risk. Look for opportunities.

***AUCTIONS***

| | next auc. | offer | avg yield last | last auction date |
|---|---|---|---|---|
| 13 Week T-bills | - | - | 6.061% | 7/28/2008 |
| 26 Week T-bills | - | - | 6.409% | 9/15/2008 |
| 52 Week T-bills | 10/20/2008 | - | 6.295% | 10/13/2008 |
| 2Y T-bond OK0710 | 12/3/2008 | - | 6.471% | 8/6/2008 |
| 5Y T-bond PS0413 | 11/5/2008 | - | 5.926% | 10/1/2008 |
| 10Y T-bond DS1019 | TBA | - | 6.054% | 4/9/2008 |
| 20Y T-bond WS0429 | 12/9/2008 | - | 5.992% | 9/10/2008 |

## Money Market

*Expensive carry on global crunch basis*

*Introduction of new monetary policy instrument is the key to avoid further turmoil*

*T-bill's yields fell at the tender.*

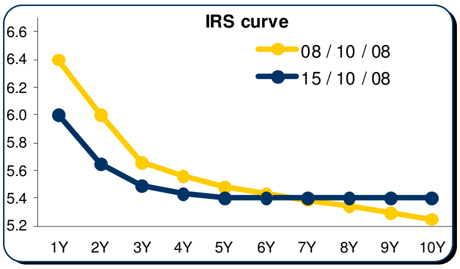
Liquidity problems have dominated all other activities this week. The central bank has prepared package for banking sector to boost confidence. New monetary policy should facilitate access to cash and restore trust in the banking system which was battered last week.
Liquidity concerns keep cash rates high and we believe this situation will remain until new monetary instruments are introduced.

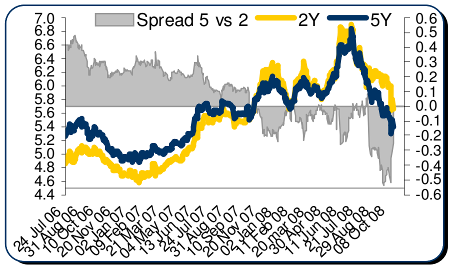
The average yield on Polish benchmark 52-week T-bill fall to 6.295% from 6.395% at previous tender and the 13-week T-bill fall to 6.173% from 6.362%. In total, The Ministry sold all 1.61 billion PLN of papers. OIS spreads have widened and there is small turnover in this market.

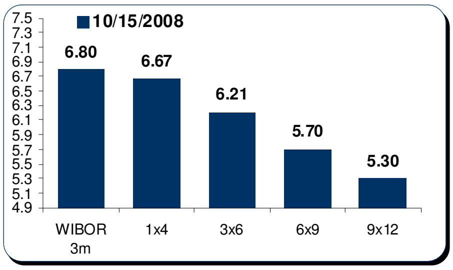
***RECOMMENDATION:***

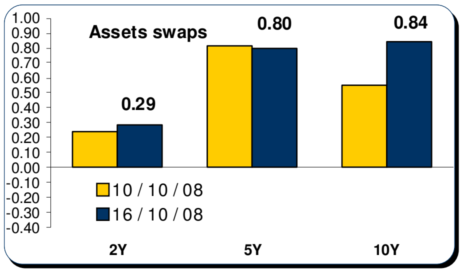
Pay OIS up to 2 months at current levels

***FIXED INCOME & MONEY MARKET CHARTS***




## Foreign Exchange

*Zloty weaker*

Zloty's market has faced next week of high volatility trading. This week EURPLN has found low at 3.4280 and high at 3.6250. Similar USDPLN has been traded with 2.4860 bottom and 2.5820 top. Market became even more volatile as rumour ,Hungary joining country club infected by global crisis, has been spread.

*Volatility still high*

It was another week of high volatility than week before. Curve remained at extreme high levels – EUR/PLN 1M was quoted at 22.00 and 1Y at 11.50 while week before quotations had been at 18.0 and 9.0. USD/PLN 1M moved from 23.00 to 29.00 and respectively 1Y from 16.00 to 18.50.

***RECOMMENDATION:***

SPOT

Main supports / resistances:
EUR/PLN: 3.4900 / 3.7300
USD/PLN: 2.4950 / 2.7600

*Sell PLN*

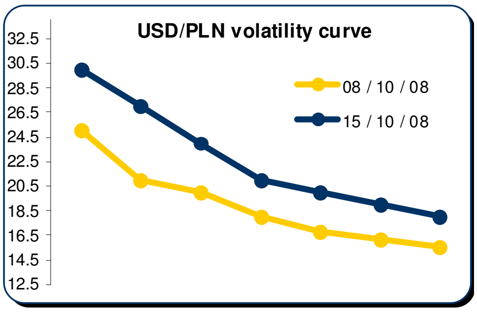
It is unlikely volatility will decrease in nearest future, therefore we suggest selling PLN at 3.49 with S/L at 3.44 and P/T at 3.65 or play trend hand-in-hand with temporary trend.

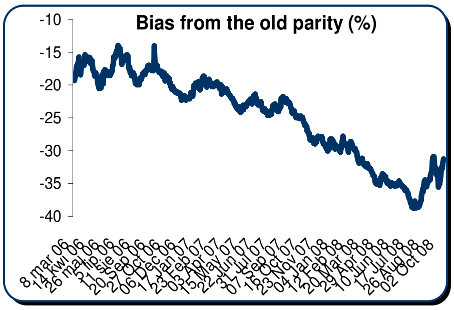
OPTIONS

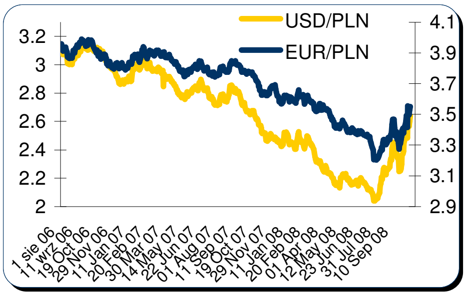
*Short vega*

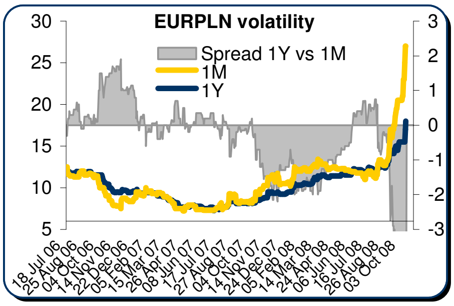
We believe in receiving some benefits from short vega especially on 6M and 1Y selling.

***FX CHARTS***


USD/PLN volatility curve
08 / 10 / 08
15 / 10 / 08
32.5
30.5
28.5
26.5
24.5
22.5
20.5
18.5
16.5
14.5
12.5


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


USD/PLN
EUR/PLN
3.2
3
2.8
2.6
2.4
2.2
2
4.1
3.9
3.7
3.5
3.3
3.1
2.9


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
30
25
20
15
10
5
3
2
1
0
-1
-2
-3

# MARKET PRICES UPDATE

## MONEY MARKET RATES

Money market rates (Closing mid-market levels)

| date | 3M | | 6M | | 1Y | |
|---|---|---|---|---|---|---|
| | FXSW | WIBOR | FXSW | WIBOR | FXSW | WIBOR |
| 09/10/08 | 6.70% | 6.82% | 6.70% | 6.76% | 6.67% | 6.77% |
| 10/10/08 | 6.70% | 6.81% | 6.73% | 6.76% | 6.75% | 6.77% |
| 13/10/08 | 6.66% | 6.80% | 6.70% | 6.76% | 6.72% | 6.77% |
| 14/10/08 | 6.66% | 6.80% | 6.70% | 6.75% | 6.72% | 6.77% |
| 15/10/08 | 6.65% | 6.81% | 6.72% | 6.75% | 6.74% | 6.78% |

## FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

| date | 1X4 | 3X6 | 6X9 | 9X12 | 6X12 |
|---|---|---|---|---|---|
| 09/10/08 | 6.68% | 6.18% | 5.67% | 5.31% | 5.51% |
| 10/10/08 | 6.68% | 6.27% | 5.79% | 5.35% | 5.61% |
| 13/10/08 | 6.64% | 6.09% | 5.57% | 5.17% | 5.45% |
| 14/10/08 | 6.60% | 6.05% | 5.53% | 5.12% | 5.36% |
| 15/10/08 | 6.67% | 6.21% | 5.70% | 5.30% | 5.53% |

## 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 |
| 09/10/08 | 6.77% | 5.08% | 5.57% | 5.29% | 5.72% | 5.69% | 5.73% | 5.76% |
| 10/10/08 | 6.77% | 5.05% | 5.57% | 5.29% | 5.71% | 5.68% | 5.72% | 5.76% |
| 13/10/08 | 6.77% | 5.05% | 5.57% | 5.34% | 5.71% | 5.67% | 5.71% | 5.76% |
| 14/10/08 | 6.77% | 5.05% | 5.56% | 5.30% | 5.71% | 5.65% | 5.72% | 5.75% |
| 15/10/08 | 6.78% | 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 | 08/10/13 | 09/10/08 | 94.016 | 6.30% | 800 | 1872 | 811 |
| OK0710 | 08/08/06 | 10/07/25 | 88.390 | 6.47% | 1800 | 3724 | 1830 |
| PS0413 | 08/10/01 | 13/04/25 | 99.132 | 5.93% | 1800 | 4924 | 1856 |
| DS1017 | 08/10/08 | 19/10/26 | 97.121 | 5.86% | 2500 | 4472 | 2500 |

## FX VOLATILITY

| | USD/PLN 0-delta stradle | | | | 25-delta RR | | 25-delta FLY | |
|---|---|---|---|---|---|---|---|---|
| date | 1M | 3M | 6M | 1Y | 1M | 1Y | 1M | 1Y |
| 09/10/08 | 23.00 | 18.00 | 16.75 | 15.50 | 2.50 | 2.20 | 0.30 | 0.35 |
| 10/10/08 | 23.00 | 18.00 | 16.75 | 15.50 | 2.50 | 2.50 | 0.30 | 0.35 |
| 13/10/08 | 25.00 | 19.00 | 18.00 | 15.50 | 2.50 | 2.50 | 0.30 | 0.35 |
| 14/10/08 | 27.00 | 19.00 | 18.00 | 17.00 | 3.00 | 3.00 | 0.40 | 0.40 |
| 15/10/08 | 27.00 | 21.00 | 20.00 | 18.00 | 3.50 | 3.00 | 0.40 | 0.40 |

## PLN SPOT PERFORMANCE

PLN spot performance

| date | USD/PLN | EUR/PLN | bias |
|---|---|---|---|
| 09/10/08 | 2.4835 | 3.4161 | -33.98% |
| 10/10/08 | 2.6115 | 3.5548 | -32.79% |
| 13/10/08 | 2.6029 | 3.5484 | -32.55% |
| 14/10/08 | 2.5652 | 3.4959 | -32.70% |
| 15/10/08 | 2.5998 | 3.5304 | -31.75% |

*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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