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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of October 24th to October 30th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
MPC decision	**29 Oct**	-	**6.0%**	6.0%	6.0%	Despite weaker projection, the MPC to stay on hold and compensate this way the higher risk premium demanded by foreign investors amid extreme high FX volatility. We expect lower rates in Q1 2009.

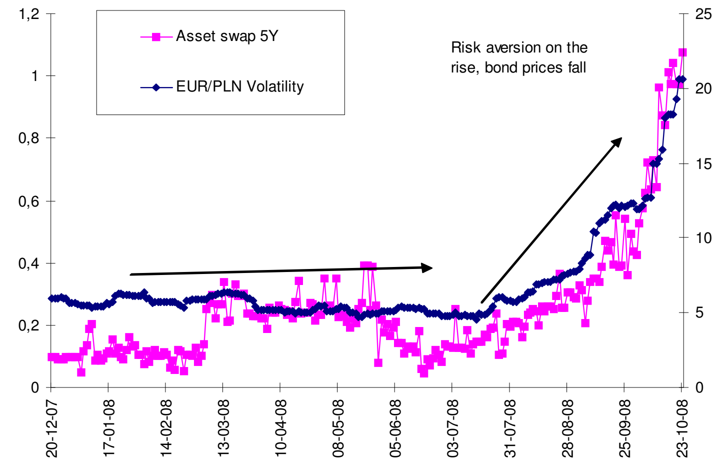
In Focus / Macroeconomics

Poland hit by portfolio outflow from EM – MPC in different "regime" at the moment

2003 comes back: Polish economy once again imported the crisis from Hungary. As investors sought to reduce the exposition in the region, Polish market seemed relatively deep and liquid (at least in comparison to the Hungarian one) to do the trick. Massive depreciation of the zloty (and its high implied volatility) has changed the regime within which the monetary policy is conducted. As a consequence, the chances for policy easing already this year has fallen significantly.

Softening local real sphere and the ongoing global slowdown induced the MPC to enter the disinflation regime in which the projected GDP gap is sufficient to keep price pressures contained and, at the same time, allow for monetary easing to give a boost to faltering real economy. That is why we attached 50% probability of a monetary easing till the end of the year. Today's retail sales data brought another confirmation for the above-mentioned thesis. First half of the year saw average retail sales growth rate of 17.6% y/y, after 3 months of the second half the dynamics nearly halved reaching 10.9%. Lower consumer confidence and deteriorating business conditions in retail sector suggest a new equilibrium in internal trade is on its way. Nevertheless, it is retail sales what is set to remain the main GDP contributor in the coming months, especially when taking into account the relatively poorer performance of industry.

As risk aversion recently intensified, the MPC can no longer ignore this fact. That is why we think we have temporary left the disinflation regime, or disinflation phase, in favor of risk aversion regime. The current state suggest the MPC can no longer rely on the macro data only – it should monitor closely the financial markets as well (such a policy has been followed – quite successfully – by the National Bank of Hungary which interest rates reflect, to a significant degree, the movements of the risk premiums). However, we do not expect the MPC to make a preventive strike (25 bp. hike would be clearly insufficient, inducing only the inflow of speculative capital, whereas the greater scale of a hike seems to be unacceptable for the MPC at the moment). Hence, the most probable scenario includes rates on hold till the end of the year. Should the volatility decline, we may expect a re-switch to disinflation regime (see the graph below).



As core inflation rose again in September, there are more and more concerns that the ongoing FX turmoil will lift the core (and headline) measures further (instead of gradual decline induced by the business cycle phase). We regard such reasoning as hard to square with the facts. First of all, zloty depreciations is accommodated by the falling oil prices. Secondly, it is only a small portion of consumption basket which is vulnerable to exchange rate movements. The natural experiment from 2003 (when the zloty lost about 10% versus the euro) suggests, the depreciation left the prices almost intact. Core "net" inflation stayed in interval of 0.2-0.5 pp. in October 2003-April 2004 period. It is worth to note that during that time, GDP growth was running at about 5%. Contemporary growth perspectives look gloomier; hence the price pressures may be even better contained than in 2003/2004.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.1	3.0
Inflation rate (%, average)	1.0	2.4	4.4	2.9
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	4.8	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

What about the risk?

Last week was quite exceptional. When am writing this bit 2y IRS is trading at 7.10, 5y is virtually no offer and bonds are yielding +8% on every maturity possible. When 2 weeks ago we recommended closing all receive positions we didn't have slightest idea in what mess market can end up. From extraordinary meeting and expecting intra meeting cut we now end up with possibility of emergency hike because of currency crisis. Daily volatility is now reaching 50 bp, which is translating to 100% annualized volatility. In such circumstances no one can be sure where market can be in next 24 hours. But we have 'feeling' that in 1 year time rates and bond yields can be lower, if not much lower. Everything and everyone is working to put the world in order, what we observe right now is concentrated in time panic liquidation of any risk. Deleveraging is becoming absurd, and is thorn so far from fundamentals that it must create opportunities. We are keen to use this opportunity. We like to receive 2y at current levels, in small risk, but we rather receive these rates than to pay them. Risk like brave.

RECOMMENDATION:

Receive 2y at current levels

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.257%	10/20/2008
26 Week T-bills	-	-	6.409%	9/15/2008
52 Week T-bills	10/27/2008	-	6.395%	10/20/2008
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

Introduction of repo and FX swap by Central Bank

This week Polish Central Bank offered repos and foreign currency swaps for banks as a part of "confidence package". Last Friday CB added 9,8 billion PLN on 6 day repo and in the same time offered money bills in regular OMO for 7,3 billion PLN. On Tuesday CB added 9.3 billion PLN in 14 days repo (at an average rate of 6.16) to the banking sector. Starting with Oct 23 CB offers FX swaps on a daily basis in USD/PLN and EUR/PLN with 7 – day maturity.

Cash surplus caused short term interbank rates dropped down

As a result there is a nice surplus of cash in the system. Interbank short term rates are low and near deposit rate in CB. Despite the fact that the rates are low, confidence didn't come back and long term deals are no practically longer available. Banks are more careful when lending money to each other and number of loans on the interbank market can be divided by two.

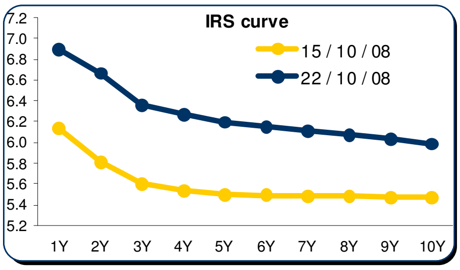
T-bill's yields up at the tender.

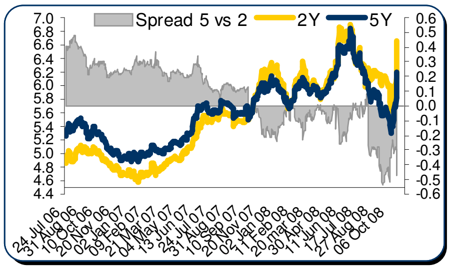
The average yield on Polish benchmark 52-week T-bill up to 6.395% from 6.295% at previous tender and the 13-week T-bill up to 6.257% from 6.173%. In total, The Ministry sold only 0.783 billion pln of papers from 3 billion PLN offer.

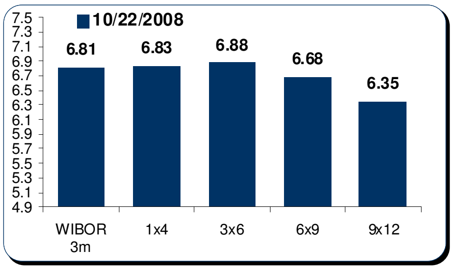
RECOMMENDATION:

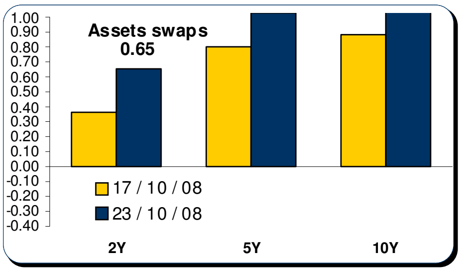
Offer 1 Y swap at current levels

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

Zloty's market has faced extremely high volatility trading. This week EURPLN opened with low at 3.5200 and high at 3.9880. Similar USDPLN has started with 2.6000 bottom and ended 3.1100 top. Poland has imported crisis from Hungary, so weakening HUF and strengthening USD were behind this move.

Volatility still high

Volatility curve reached new highs – EUR/PLN 1M was quoted at 28.00 and 1Y at 15.50 while week before quotations had been at 22.0 and 11.5. USD/PLN 1M moved from 29.00 to 35.00 and respectively 1Y from 18.50 to 22.00.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 3.7400 / 4.0000
USD/PLN: 2.6700 / 3.3900

Buy PLN

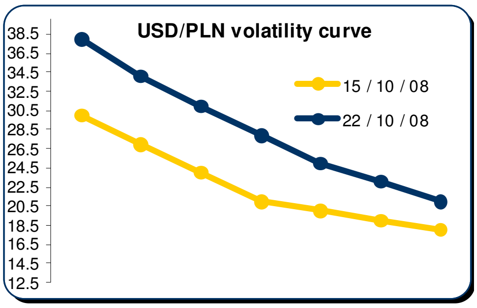
PLN market looks heavily oversold, so long PLN positions at 4.00 are looking like easy money. Beware of low liquidity trading.

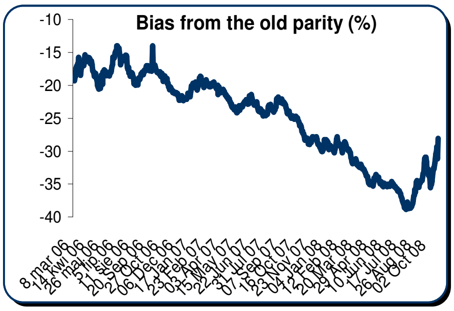
Short vega

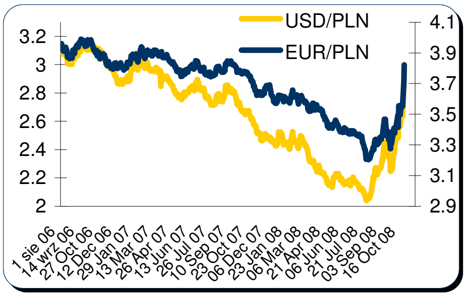
OPTIONS

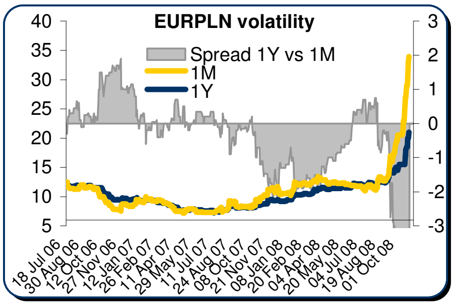
We believe in receiving some benefits from short vega especially on 6M and 1Y selling.

FX CHARTS


USD/PLN volatility curve
15 / 10 / 08
22 / 10 / 08


Bias from the old parity (%)


USD/PLN
EUR/PLN


EURPLN volatility
Spread 1Y vs 1M
1M
1Y

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
16/10/08	6.74%	6.81%	6.75%	6.76%	6.79%	6.78%
17/10/08	6.70%	6.82%	6.71%	6.74%	6.75%	6.78%
20/10/08	6.63%	6.80%	6.65%	6.75%	6.68%	6.76%
21/10/08	6.64%	6.81%	6.68%	6.75%	6.69%	6.75%
22/10/08	6.62%	6.81%	6.65%	6.77%	6.69%	6.77%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
16/10/08	6.73%	6.36%	5.80%	5.37%	5.65%
17/10/08	6.71%	6.45%	5.91%	5.53%	5.70%
20/10/08	6.71%	6.40%	5.85%	5.50%	5.72%
21/10/08	6.73%	6.52%	6.00%	5.63%	5.85%
22/10/08	6.83%	6.88%	6.68%	6.35%	6.57%

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
16/10/08	6.78%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
17/10/08	6.78%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
20/10/08	6.76%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
21/10/08	6.75%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
22/10/08	6.77%	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	08/10/20	09/10/20	93.920	6.40%	1000	739	495
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
16/10/08	29.00	22.50	20.50	18.50	4.00	3.00	0.40	0.40
17/10/08	29.00	22.50	20.50	18.50	0.00	0.00	0.00	0.00
20/10/08	30.00	25.00	23.00	20.00	0.00	0.00	0.00	0.00
21/10/08	33.00	25.00	23.00	20.00	0.00	0.00	0.00	0.00
22/10/08	34.00	28.00	25.00	21.00	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
16/10/08	2.6385	3.5506	-31.32%
17/10/08	2.6509	3.5653	-30.41%
20/10/08	2.6354	3.5515	-30.05%
21/10/08	2.7199	3.5962	-29.34%
22/10/08	2.8812	3.7139	-31.17%

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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