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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of November 21st to November 28th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Retail sales y/y	**Nov 26**	Oct	**7.9%**	9.1%	11.6%	No working days effects on annual basis. Falling business tendency indicators are sufficient to bring the sales growth down the consensus and the last reading.
MPC decision	**Nov 26**	-	**5.75%**	6.0%	6.0%	We expect a rate cut in the coming meeting – today's data have changed nothing. The prospects for the economy are gloomy and arguments against cuts which are based on rate disparity are ill suited – there is only a little chance the zloty will additionally depreciate as rate cuts are already priced in.
GDP growth y/y	**Nov 28**	Q3	**4.7%**	4.8%	5.8%	Still the figures far form a sharp descent. We expect this to change in the coming quarters. Business tendency indicators suggest the deceleration may be quite rapid with the most negative scenario including a trough at 0-1% y/y.

In Focus / Macroeconomics

Current data not an obstacle for November cut

This week's data were neutral for the FI market as liquidity stayed low. Although we saw a relatively large reading on wages, it is not the phase of the cycle in which this aggregate may pose a serious threat. Inflation is in retreat (including most "sensitive" items such as food and fuels). This combined with the softening labor market (we are not far from the point where lay-offs prevail) actually wipes out the possibility of second round effects. The production sphere is decelerating sharply leaving spare capacities – it implies not only a cut back on investment spending but also on jobs…Let's look at some issues of the passing week more thoroughly (see also the separate piece on policy mix).

Employment and wages. The data on employment and average wage did not substantially diverge from the market consensus. The growth rate of the former amounted to 3.6% y/y, down from 4.1% recorded last month, whereas the latter almost sustained the momentum (taking into consideration the lack of working days difference between months) growing by 9.8% r/r (compared with 10.9% in September). We expect the trend of both figures to bend down in the coming months. Slowing economy and the enactment of the cost cutting process are going to make wage bargaining harder for employees, intensifying at the same the process of lay-offs. The data activated some relatively hawkish comments but, as have we already mentioned in the opening paragraph, we see the wage data as relatively irrelevant in this phase of the cycle but, alas, sufficient for some members to prove their hawkish views.

Industrial output and producer prices. Producer prices accelerated to 2.4% y/y but the movement owes much to the revision of data which inflated annual figures. The more useful (in the light of seeking for the turning point) monthly variation was in line with our expectations: prices in manufacturing went down by 0.2%. We see this trend to extend into the coming months; the underlying factors include low levels of crudes (forward contracting implies that pass-through of lower prices is set to occur in full force in coming months) and ailing economy, putting reins at pricing powers of individual forms. In these circumstances we expect the depreciating currency to have minor impact on producer prices in coming months.
Industrial output fell short of expectations by reaching 0.2% y/y (previous reading revised down to 6.8%y/y). The downward pressure was exerted mainly by utilities and mining whereas manufacturing posted 1.3 annual growth - consistent with recent PMI readings. We expect industrial output to contract sharply in November as companies (see almost 10% drop of auto industry production) are likely to further cut back on investment (with current spare capacities...) and on intermediate goods. Moreover, there are statistical effects working towards a lower reading (2 working days less on annual basis).

Polish economy is set to contract in coming months (business tendency indicators – namely the PMI, show that Polish GDP may even bottom to about 0-1%). In these circumstances it would be (for the majority of members) impossible to neglect the disinflationary forces which are mounting on the horizon. All this may trigger a rate cut already in November. We are aware that some MPC members may be afraid that narrowing rate disparity may be harmful for the zloty. We see such arguments as irrelevant as the current exchange rate levels already "include" expectations of rate cuts (see the shape of the yield curve).

Polish FinMin vocal on policy mix

Amid slowing economy, Polish FinMin firmly believes in the fiscal stability next year. Polish prudent fiscal rules, in his opinion, will open the door for monetary policy easing "necessary to stimulate the weakening economy". The economic situation, far worse than the government anticipated when the budget bill was constructed in September, may significantly reduce the budget revenues next year. The downsizing of the GDP growth from 4.8 to 3.8% - likely to be announced next week - is to lower the state revenues by about 4 PLN bn in 2009. In order to avoid the negative reaction of financial markets, and fix the next year budget deficit, the FinMin will probably have to cut spending by the same amount.

This time it is not only the budget figure which has potential to move the markets, though. Much more worrisome are the funding issues – the government has to roll about 90 PLN bn of debt next year. Widening assets swaps are making the funding much more problematic nowadays and the government is trying to fund the deficit issuing treasury bills. Financing the budget at the very front end of the yield curve also explains why the eventual rate cuts find so much support from the Ministry of Finance.

We are quite confident that trend-deterioration in Polish fundamentals will accelerate in early 2009. This in conjunction with worries about fiscal stability and funding issues may, at least temporarily, elevate the long end of the Polish government bond curve. Also the euro adoption issue has not been settled yet. Central Bank and the Ministry of Finance agree that constitution has to be changed before ERM2 entry; it is impossible to accomplish without the votes form Law and Justice Party. There is a light at the end of the tunnel for the government though, as they need votes of only 4 members of the opposition party to tip the scale (according to Rostowski), which, in turn, makes constitution change easier than it is commonly believed (especially when we realize that the government is really determined towards joining the EMU)…upward pressure of the long end of the curve may thus be a subject to relatively high volatility.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.2	**1.8**
Inflation rate (%, average)	1.0	2.4	4.3	3.3
Current account (% of GDP, average)	-2.1	-4.5	-4.6	**-5.7**
Unemployment rate (end-of-year)	14.9	11.4	9.4	**11.2**
NBP repo rate (end-of-year)	4.00	5.00	6.00	4.75

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.8	4.7	**3.5**	**2.9**	**1.6**
Inflation rate (%, average)	4.3	4.7	3.8	3.5	3.3
NBP repo rate (end-of-quarter)	6.00	6.00	**5.50**	**5.25**	5.00

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

Fixed Income

Not much of a change.

This week hasn't changed much on the FI market. Rates moved down again by some 10-20bp, the curve steepened by some 10bp, however liquidity remains poor and turnover stays low.
Also the economic data published this week didn't bring much new to the picture. Still high core inflation and wages data will be definitely used by the hawks to postpone policy easing, however we still think that doves will get the majority next week and rates will fall by 25bp. However, looking at cash market, liquidity premium is still high, and is likely to stay this way, so such move will not be fully reflected by Wibor rates going down, it should still be positive for the front end of the curve and increase expectations for further easing next year. Therefore we stick to our steepening view and keep positioned in 1y10y spread.

RECOMMENDATION:

Stay positioned for steeper curve.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.568%	11/17/2008
26 Week T-bills	-	-	6.409%	9/15/2008
52 Week T-bills	12/8/2008	-	6.733%	11/17/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
5Y T-bond PS0413	2/6/2009	-	5.926%	10/1/2008
10Y T-bond DS1019	2/13/2009	-	6.054%	4/9/2008
20Y T-bond WS0429	12/9/2008	-	5.992%	9/10/2008

Money Market

Very cheap days

Market is frozen as of now

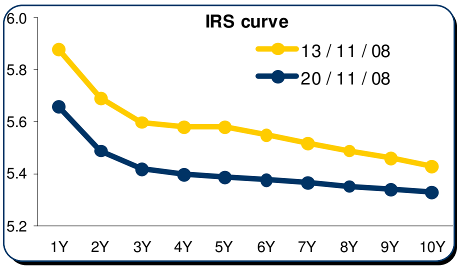
Extremely cheap week due to huge surplus of the cash in the system. Market bought 10.8 billion pln in money bills, out of 13 billion maturing at the same date. This would not affect shortest rates in such a scale, however repo operation took place in the mean time, and additional 5 billion pln showed up for 3M period. As of today, the reserve requirement is overbuild in the amount of 7 billion pln. This makes us think that another week will be even cheaper.

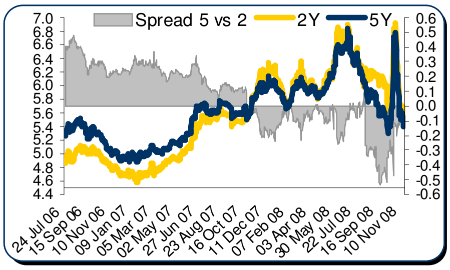
Not too much action on trading. Spreads has widened, amount of counterparties has shrunk, and any trade is being born in pain.

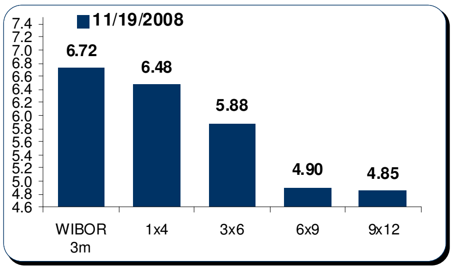
RECOMMENDATION:

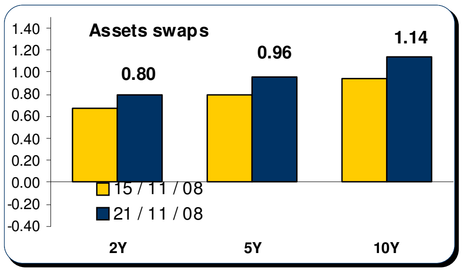
Sell short polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty consolidating at weaker levels

We have had already three unsuccessful attempts to break 3.87/3.90 resistance. We think 3.9000 is acting now as pivotal, and the most market participants are believing in 4.1000 or higher in the comings weeks .

Volatility has exploded

Volatility curve for EUR/PLN and USD/PLN have reached it is all time high (again), (with EUR/PLN 1M at 40 % and 1Y at 21.5, for USD/PLN it was respectively 55 %1m and 33 % 1y). There is a disaster already included in the current volatility levels.

RECOMMENDATION:

SPOT
Main supports / resistances:
EUR/PLN: 3.6500 / 3.9000
USD/PLN: 2.8000 / 3.1500

Play range 3.900 pivot

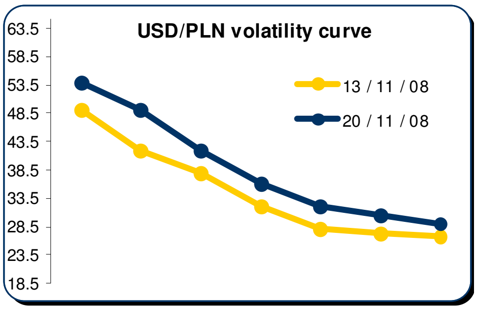
Play range. But breaking the 3.9000 really crucial resistance would suggest fast move to 4.000.

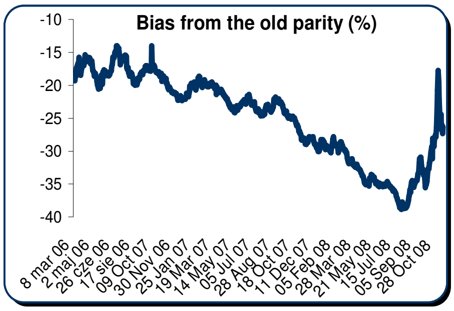
Short vega

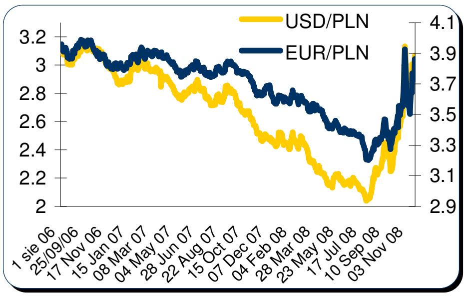
OPTIONS

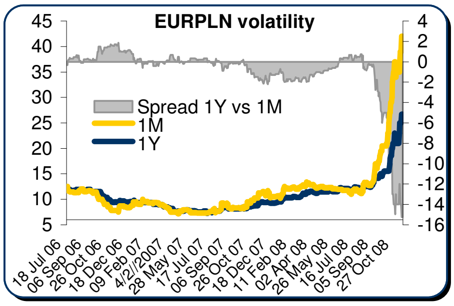
We (still) believe in short vega especially in 6M and 1Y. It is now almost 25% up, from last week with spot (historic volatility) not really justifying such a big jump. We blame VAR related stop losses of the short convexity portfolios.

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
14/11/08	6.64%	6.77%	6.70%	6.49%	6.73%	6.59%
15/11/08	6.65%	6.76%	6.72%	6.72%	6.74%	6.75%
18/11/08	6.59%	6.73%	6.67%	6.71%	6.71%	6.74%
19/11/08	6.66%	6.71%	6.72%	6.70%	6.73%	6.74%
20/11/08	6.60%	6.72%	6.68%	6.71%	6.72%	6.74%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
14/11/08	6.47%	5.93%	5.28%	5.18%	5.26%
15/11/08	6.48%	5.90%	5.23%	5.10%	5.22%
18/11/08	6.47%	5.84%	5.05%	4.95%	5.14%
19/11/08	6.48%	5.70%	4.98%	4.93%	4.99%
20/11/08	6.48%	5.88%	4.90%	4.85%	5.00%

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
14/11/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
15/11/08	6.75%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
18/11/08	6.74%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
19/11/08	6.74%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
20/11/08	6.74%	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	08/11/17	09/11/17	93.626	6.73%	1200	2540	1198
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
14/11/08	42.00	32.00	28.00	26.75	9.00	8.50	1.20	1.20
15/11/08	42.00	32.00	28.00	26.75	9.00	8.50	1.20	1.20
18/11/08	45.00	33.00	30.00	26.75	9.00	8.50	1.20	1.20
19/11/08	47.00	35.00	32.00	28.00	9.00	8.50	1.20	1.20
20/11/08	49.00	36.00	32.00	29.00	9.00	8.50	1.20	1.20

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
14/11/08	2.9457	3.7348	-24.45%
15/11/08	2.9457	3.7348	-24.45%
18/11/08	3.0665	3.8623	-26.04%
19/11/08	3.0502	3.8444	-27.31%
20/11/08	3.0845	3.8620	-26.34%

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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