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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of January 30th to February 5th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
PMI	**Feb 2**	Jan	**37.7 pts**	-	38.3 pts.	We witnessed another deterioration of business tendency indicators in January. However, the dynamics of falls have slightly eased which is consistent with gradual falls of PMI (currently at the levels of really gloomy activity).
MinFin's inflation forecast y/y	**Feb 2**	Jan	**2.8/2.9%**	3.1%	3.3%	Around half of the electricity hike included in January data. Another fall of fuel prices (2-3% m/m). Prices in core categories stable on monthly basis. We estimate core inflation including food and energy at 2.1% (publication scheduled for 21 March owing to the change of consumption basket).

In Focus / Macroeconomics

Polish rates cut by 75bps

As expected, the MPC cut the rates by 75bps to 4.25%, the level last seen in May 2007. The Committee agreed that the balance of risks shifted further towards the much lower economic growth (recessions among the main trading partners, credit crunch in Poland) and lower inflation. This time the MPC acknowledged the CPI inflation will decline not only in the mid-term but also in short-term as well, being driven by lower wages and deteriorating employment outlook.

The Committee also touched on the topic of zloty depreciation and its opinion resembles ours. The most recent sharp depreciation has been mainly driven by capital outflow from all emerging markets accompanied by some one-off factors like unwinding currency options, and is not directly linked to the narrowing of interest rate differential between Poland and euro zone. Weaker zloty due to a sharp economic slowdown will, in our opinion, also have very limited impact on consumer prices in Poland.

All in all, we do not see the events in the FX market as an obstacle for further aggressive rate cuts. During the Q&A session the NBP president indicated that the NBP inflation projection, to be released in February, is to plot much lower GDP and inflation paths. As we expect the economic momentum to rapidly deteriorate in the short term (we forecast a double digit drop in industrial production, inflation to fall below 3% in January and corporate wages to slow down under 5% y/y) it is more and more likely that the pace of economic easing will accelerate as well and the rates will fall to 3% by the end of Q1 2009. We think that the government's short term stance on fiscal policy (it is not willing to increase the deficit soon, see the piece below) may favor more aggressive rat cuts.

Turning to the most recent comments by MPC members, hawkish members point to a continuation of rate cutting cycle and that the decision to cut the rates quickly reflects the broader consensus in the monetary policy body. Filar updated his estimates for 2009 inflation; it may now be well contained within the NBP target range of 2.5% +-1 pctg. point. As Wasilewska-Trenkner ruled out the possibility that the Committee would lower the rates to as low as 2%, we think that this may rather stimulate the market expectations for lower rates than set a real limit for the rate setters.

The government finally re-estimates the scale of the slowdown

It was only a matter of time and it finally did happen. The government announced the necessity to cut spending by about 17 bln PLN in 2009. The envisaged reduction is a direct consequence of deteriorated growth outlook – in the most pessimistic scenario the government now expects GDP growth rate falling to 1.7% in 2009.

Compared to 3.7% assumed earlier, the new floor set for the growth rate looks far more meaningful. However, the bottom suggested by the government actually meets the upper range of "realistic" forecasts. The fresh GDP data issued by the statistical office (GDP growth for the whole 2008) allows us to estimate the scale of slowdown experienced in Q4. It is then likely that GDP indeed hit 2.9%, meeting our earlier estimates. High frequency data suggest the slowdown has gathered pace in 2009 and we will see at least two quarters of GDP contraction (quarterly, seasonally adjusted), meeting requirements for technical recession. We see some chance for improvement in H2, although statistical effects are going to prevent annual GDP dynamics to recover quickly. The whole year GDP dynamics is very likely to fall short of 1%.

So far, the government is thriving to leave budget deficit intact. Hence the need to cut government outlays, focused on business equipment of various ministries (the breakdown to be announced next week). In the light of the scale of the slowdown, assumed spending cuts may prove to be insufficient, though. We still insist the government overestimates the growth of consumption in 2009 and thereby overstates the income side of the budget. We agree that consumption will be the last to falter during the cycle, but it does not translate into its growth persistence (the myth it cannot fall as fueled by wages instead of credit). Negative net worth of new housing (financed by mortgage), backed by cyclically higher savings rate, are unlikely to let consumption grow by more than 2% in real terms in 2009.

Our skepticism regarding the income and spending side of the budget translates fully into distrust on the level of assumed deficit – 18.2 bln PLN. Our baseline scenario assumes the budget bill is going to be amended (the possible data is close to mid-year). As usual the government's PR specialists feed the public with two messages: one really bad (the need to cut back on spending) and the one relatively optimistic. The latter includes further measures to be implemented within the framework of fiscal package for 2009, dealing mainly with improvement of credit conditions (new pool of preferential-terms credit and extended degree of state guarantees).

Government announcement may exert only a limited negative pressure on market participants now as they have been questioning the overly optimistic budget assumptions for some time. We think the FX market have already priced in the budget problems (including budget revision). There is still room for further deterioration though, as soon as ambitious government plans fail. We advise you then to closely follow the budget performance in months to come.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.0	<1.5
Inflation rate (%, average)	1.0	2.4	4.3	**2.3↓**
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-5.7
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.2
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.00

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.8	4.7	3.0	1.5	0.5
Inflation rate (%, average)	4.3	4.7	3.8	**2.8↓**	**2.1↓**
NBP repo rate (end-of-quarter)	6.00	6.00	5.00	**3.00↓**	3.00

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

Fixed Income

Another cut. And more to come.

75bp rate cut delivered this week was a bit more than the market consensus, however positive reaction to that was quite limited and shortly after rates started pushing higher. If adjusted by recent movement on Wibor rates, current level of 2Y is actually some 30bp higher than it was about a week ago. We start to think it's a bit to early to consider further tightening as completely priced in and positive forward rates from 6x9 onwards don't seem fully justified. In current environment, when worst data are still to come (January readings are likely to show CPI at 3.0% or below, and Industrial Output falling by more than 10% y/y and in February possibly even by more) it's difficult to expect rate setters to react differently than by further easing. Wherever the cutting cycle would actually end (and that could be rather lower than higher) it's tricky to expect rates to start going higher again soon from these levels. Therefore 2Y IRS starts to look attractive to receive again. We also still like short maturity bonds as they're still yielding above main rate and keep overperforming derivatives.

RECOMMENDATION: Stay long in short maturity bonds. Receive 2Y on upticks.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	6.197%	12/9/2008
52 Week T-bills	2/2/2009	-	4.630%	1/26/2009
2Y T-bond OK0711	2/4/2009	-	5.054%	1/7/2009
5Y T-bond PS0413	2/4/2009	-	5.616%	12/17/2008
10Y T-bond DS1019	2/11/2009	-	5.724%	12/17/2008
20Y T-bond WS0429	2/11/2009	-	5.369%	1/14/2009

Money Market

Cheap end of reserve settlement period

After buy-out of Central Bank KRNNBP0312 bonds last week (3 years ahead of the schedule) there was additional 8.2 billion PLN in the interbank system. Banks used this additional cash to buy NBP bills on Friday's OMO. Demand was higher by approximately 8 billions PLN than previous tender and amounted to 25.8 billion PLN. Even such a huge OMO didn't help current reserve requirement which is overbuilt and this week short term interest rates were low.

T-bill's yields up at the tender.

The average yield on Polish 52-week T-bill at primary tender down to 4.63% from 4.748%. The Ministry sold all 1.1 billion papers from the offer.

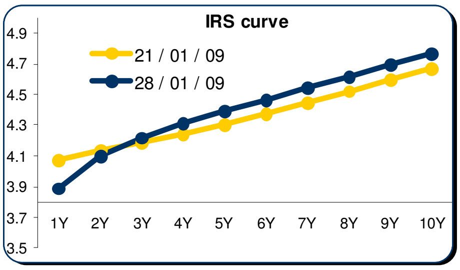
Interest rate down by 75 bps

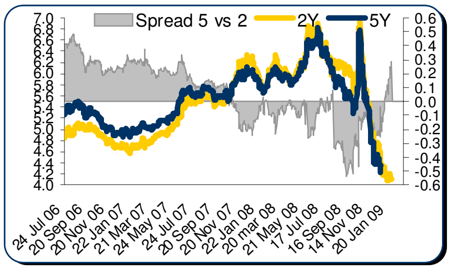
On Tuesday MPC cut interest rates by 75 bps . The main interest rate stays now at 4.25%
We expect more cuts approximately of 125bps in the first half of the year.

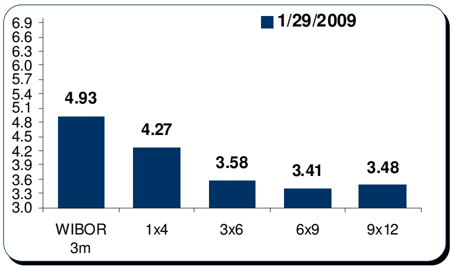
RECOMMENDATION:

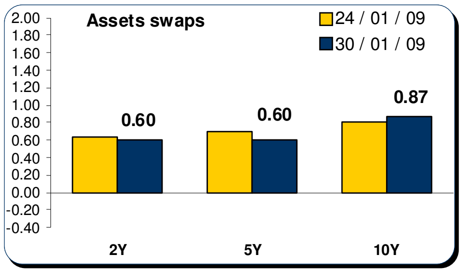
Sell 1Y Polonia OIS at 2.75 and higher

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in side trend

This week zloty was trapped in 4.3050-4.4110 range. Market position looks pretty long currency, customers EUR shorts were reduced a lot, uncertainty about polish GDP growth and deficit gap remains.

Volatility a bit lower

Zloty in range means realized volatility is decreasing, so implied does, 1M was traded at 26 (above 30 last week) and 1Y at 19.50 (20.50 respectively).

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.1500 / 4.5500
USD/PLN: 3.1600 / 3.6000

Short EURPLN/stay away

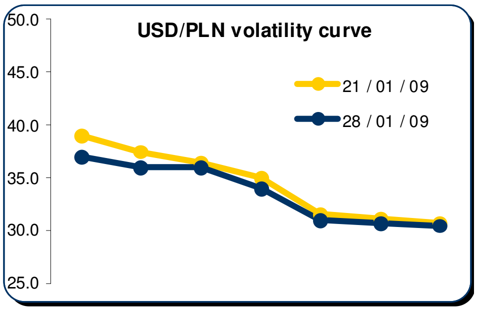
We see 4.50/4.55 as medium term target, so rest of market do. We suggest selling between 4.50/4.55 with 4.65 S/L and 4.15 P/T. Otherwise we suggest waiting for signals 4.55 won't be broken and selling then.

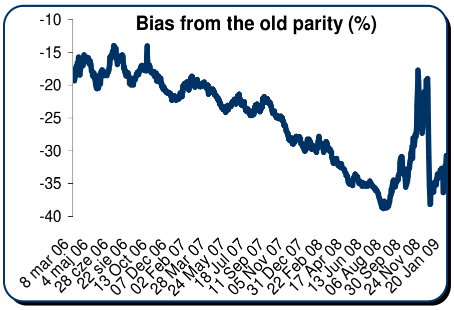
OPTIONS

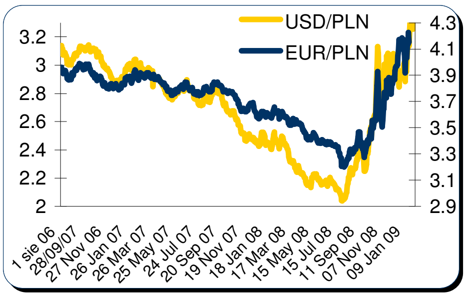
Short vega

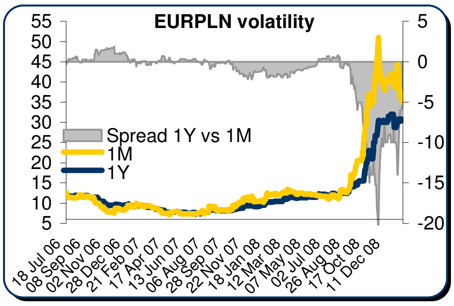
We believe in receiving some benefits from selling vega, especially 6M-1Y tenors.

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
22/01/09	5.43%	5.43%	5.53%	6.49%	5.55%	6.59%
23/01/09	5.25%	5.36%	5.49%	5.37%	5.46%	5.41%
26/01/09	5.19%	5.31%	5.54%	5.31%	5.32%	5.36%
27/01/09	4.65%	5.15%	5.35%	5.16%	5.15%	5.26%
28/01/09	4.74%	4.93%	5.26%	4.89%	4.86%	4.92%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
22/01/09	4.77%	3.85%	3.43%	3.48%	3.48%
23/01/09	4.66%	3.80%	3.38%	3.48%	3.42%
26/01/09	4.68%	3.73%	3.36%	3.41%	3.43%
27/01/09	4.48%	3.64%	3.32%	3.39%	3.40%
28/01/09	4.28%	3.63%	3.33%	3.45%	3.44%

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
22/01/09	6.59%	4.66%	4.19%	4.82%	4.36%	5.15%	4.76%	5.66%
23/01/09	5.41%	4.66%	4.21%	4.84%	4.46%	5.16%	4.85%	5.66%
26/01/09	5.36%	4.66%	4.18%	4.79%	4.42%	5.08%	4.82%	5.64%
27/01/09	5.26%	4.66%	4.11%	4.71%	4.36%	4.97%	4.74%	5.62%
28/01/09	4.92%	4.35%	4.10%	4.70%	4.39%	4.99%	4.77%	5.64%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/01/26	10/01/26	95.528	4.63%	1100	3088	1100
OK0711	08/12/09	11/07/25	86.996	5.47%	2500	8037	2930
PS0413	08/12/17	19/10/25	100.558	5.62%	2500	3578	1742
DS1017	08/12/17	19/10/25	98.186	5.72%	4500	3521	2340

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
22/01/09	36.25	33.75	30.50	30.25	8.00	8.00	1.40	1.40
23/01/09	37.50	35.00	31.50	30.75	8.50	8.50	1.40	1.40
26/01/09	37.00	35.00	31.50	30.75	8.50	8.50	1.40	1.40
27/01/09	36.50	35.00	31.00	30.75	8.00	8.50	1.40	1.40
28/01/09	36.00	34.00	31.00	30.50	8.00	8.50	1.40	1.40

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
22/01/09	3.3024	4.3094	-34.41%
23/01/09	3.4380	4.3957	-34.19%
26/01/09	3.3911	4.3863	-32.31%
27/01/09	3.2549	4.3214	-32.31%
28/01/09	3.2992	4.3789	-30.77%

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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