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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of February 13th to February 19th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
CPI inflation y/y	**Feb 13**	Jan	**2.9%**	2.9%	3.3%	MinFin's inflation forecast stands at 3.2% a notch lower than previous month's reading. There is a downward risk stemming from food prices and electricity hikes (at least half of them will be reflected in CPI). Core inflation at 2.1%-2.2%.
M3 Supply y/y	**Feb 13**	Jan	**18.3%**	18.8%	18.6%	Withdrawals from mutual funds at 1-2 bn PLN. Outright drop of commercial deposits.
Employment y/y	**Feb 17**	Jan	**0.9%**	0.4%	2.1%	Further signals on group lay-offs. Seemingly high annual growth rate (taking into consideration the Jan 08 base effects) stems only from changes in the database of surveyed firms which is conditional on the past data. Overall trend clearly on the downside, confirmed by a massive rise of unemployment rate (Labour Ministry's estimate of 10.5% in January vs 9.5% in December).
Wages y/y	**Feb 17**	Jan	**4.4%**	4.8%	5.4%	Another reading consistent with falling trend. Lower business activity depresses the part of remuneration

						conditional on firms' profits.
Industrial output y/y	**Feb 19**	Jan	**-11.5%**	-12.4%	-4.4%	No difference in working days on annual basis. Further drop of business activity indicators, production hold-ups in some enterprises. Abrupt fall of demand (we remind the reader the data reflects sold industrial output). Consistent with the data on auto production in January.
Producer prices y/y	**Feb 19**	Jan	**2.3%**	2.3%	2.6%	Substantial base effect from Jan 2008. Higher prices of most PLN denominated commodities (only marginal in case of oil). Rapid PLN depreciation. Possible revision of the last month's data.

In Focus / Macroeconomics

Soaring unemployment rate

The Ministry of Labor and Social Policy forecasts unemployment rate in January 2009 at 10.5%, up from 9.5% recorded a month earlier. The forecast is based on an actual data provided by local job centers and it makes it highly reliable.

Although part of the rise of unemployment rate reflects seasonal effects and migration flows, job losses became an undisputable fact. It proves the local job market has gained flexibility since the last slowdown/recession in 2001. We may then expect the job losses to be massive and concentrated in the first half of the year (anecdotal evidence confirms the groups lay-offs are yet to come). It coincides with large falls of industrial output and quarterly GDP contraction in H1. The restructuring of companies will lead wages downwards in some sections, limiting at the same time the bargaining power of unemployed and their wage demands. It is then straightforward that demand-pulled inflation is likely to become self-contained for some time.

There is also a bright side of flexibility (see the meaningful comparisons of American and European labor markets) – the faster the economy finds a new equilibrium, the sooner it may start reversing to the long run trend. We believe that recent zloty depreciation may be highly beneficial for Polish exports (the literature documented many such cases: hence the so called J-curve effect) which may lead a recovery in the second half of the year.

Controversial rescue plan for option-troubled enterprises

Tuesday was definitely the Waldemar Pawlak's day. The deputy prime minister and the minister of economy from Peasants Party conquered the media with his draft law encompassing the ways to prevent adverse socioeconomic effects of "asymmetric currency option agreements". The main purpose of the draft law (which is to be discussed by the government next week) is to shield firms engaged in options and other derivatives with banks (the Polish Financial Supervision Authority estimates the NPV of these instruments at -15 bn PLN). Those instruments were set up in order to protect enterprises from adverse effects of the exchange rate developments. Instead of hedging real business (mainly export) flows they were used by firms mainly to speculate, though.

The draft regulation assumes three alternative ways to „solve" the problem:

1) The performance of the options will be suspended upon the promulgation of the new law. The parties to an option are then obliged to start negotiations on settlement of the claims,
2) The end-users of options will be allowed to rescind the options immediately after the promulgation of the new law,
3) All the options will be cancelled as soon as the new law is promulgated.

Surprisingly, the three above-mentioned solutions are based on alleged violation of the MiFID directive, which has not been implemented to the domestic law yet.

Turning to the macroeconomic implications, the effects for the Polish banking sector could be really devastating. Banks forced to minimize the exchange rate risk exposure would immediately unwind the inherited clients currency options (probably buying EUR on spot) pushing the EURPLN much above 5.0 mark. "Cancelling" client currency options would then trigger tremendous (and equal to the current valuations of client currency options positions) losses affecting bank's equity. In many cases the banks would have to be recapitalized by the state. As a next step wee see a credit channel to be clogged leading to a much deeper recession with all its negative – typical for emerging markets – implications for financial markets (much weaker zloty, higher costs of funding).

Fortunately, we do not expect the draft regulation to become a law. It may be attractive for some politicians to (at least temporarily) argue for it, though. We cannot rule out that even government would back the draft. The point is, however, that it will not be voted and then accepted by the

MID-TERM FORECATS

parliament in its current form.

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	3.0
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-5.7
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.7
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	3.1	2.8
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

Sentiment still following EURPLN.

Last week hasn't brought much change to the FI market. After sharp relief at the beginning of the week, rates started climbing up, reaching year highs again. Even though this move start to look a bit overdone, we still prefer to concentrate in the front of the curve, as it still seems to offer decent value and limited risk. Despite of PLN weakness, after this month set of data (CPI likely to fall below 3%, industrial output falling more than 10% y/y) MPC will decide to lower rates again, probably by 50bp. Therefore short term rates (as 4.88% on last t-bills auction) represent good value. We stick to our recommendation to hold short bonds, also 1y around 4.25% is a receiving opportunity, at least in short term, ahead of data releases and MPC decision.

RECOMMENDATION: Hold short bonds. Sell 1y3s on uptick.

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	2/16/2009	-	4.880%	2/9/2009
2Y T-bond OK0711	3/4/2009	-	5.022%	2/4/2009
5Y T-bond PS0413	3/4/2009	-	5.307%	2/4/2009
10Y T-bond DS1019	3/11/2009	-	5.724%	12/17/2008
20Y T-bond WS0429	3/11/2009	-	5.369%	1/14/2009

Money Market

Cost of carry still around the main market rate, despite of the fact that the average surplus of the cash in the system was 5 billion pln. 3M repo auction was quite successful and added net cash inflow of 3.8 billion pln to the system (maturing auction was in 5 billion pln). If tomorrow's OMO will be moderate as far as the demand is concerned, the surplus will arise increasing probability of cheap end of the reserve settlement period.

All depends on the exchange rate movement.

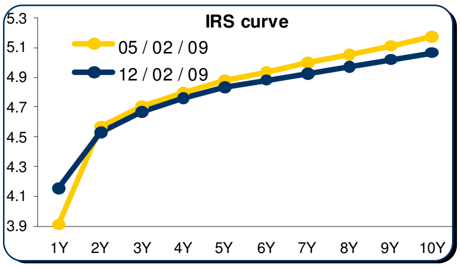
For longer terms all dependant on the exchange rate. Stronger pln triggers bullish sentiment and the other way round. Last week's depreciation put out some expectations as for the scale of the next cut. Coming figures might be the new indicators.

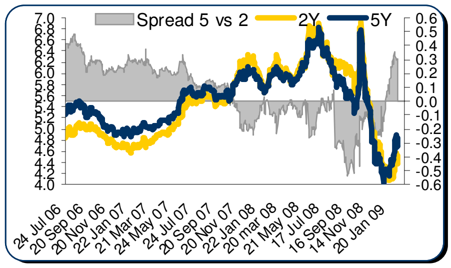
T-bills up at weekly tender

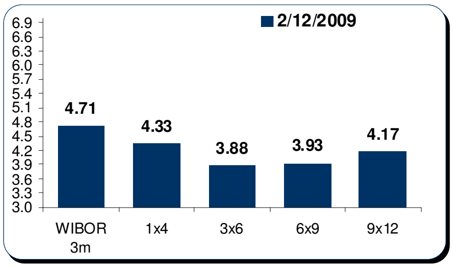
52-week benchmark t-bill gained in yield during last auction. Average rate moved from 4.44% to 4.88% matching the weak sentiment after substantial pln depreciation.

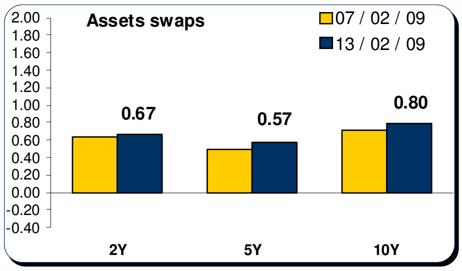
RECOMMENDATION: Offer long polonia at current levels.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty mixed

This week zloty opened at 4.5800, touched low at 4.4170 on partial P/T and then weakened toward 4.6530 on global sentiment worsening enhanced by deputy PM Pawlak idea of option cancellation.

Volatility curve flattened

Although spot market is still volatile we see curve flattening with long end a bit higher, 1M is traded at 28.0 (30.0 last week high) and 1Y at 21.0 (20 last week). We think it is related to Pawlak plan.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.2700 / 4.7000
USD/PLN: 3.4000 / 3.7500

Short EURPLN/stay away

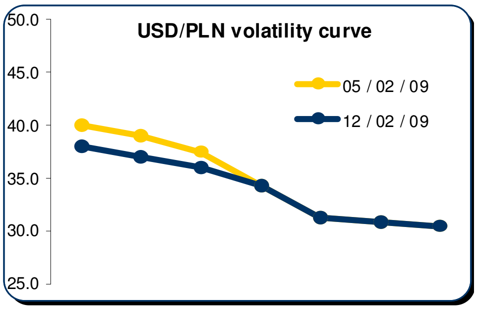
We see no signals for trend reversing. Market is following daily sentiments in wide, volatile range, but inevitably closing to 4.70 highs. It's crucial level. We suggests short position on confirmation it won't be broken, on other way wait for fresh high.

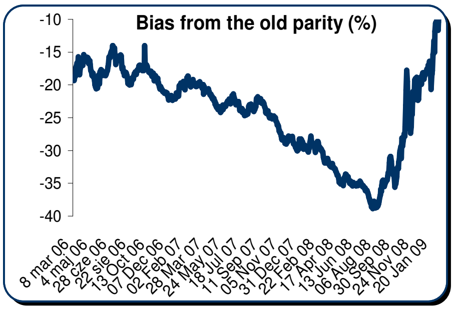
OPTIONS

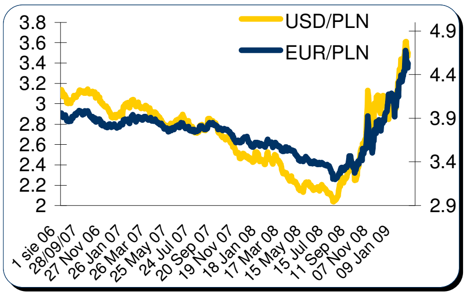
Short vega

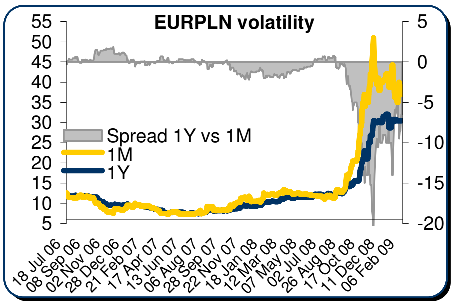
We believe in receiving some benefits from selling vega, especially 6M-1Y tenors.
For hedging we suggest buying KO options as it is cheaper due to barrier price on high volatility market. Exporters may have some benefits from selling Risk Reversals as it is nearly highs (7 vols favour call).

FX CHARTS


USD/PLN volatility curve
05 / 02 / 09
12 / 02 / 09
50.0
45.0
40.0
35.0
30.0
25.0


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


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
06/02/09	4.61%	4.76%	4.68%	6.49%	4.71%	6.59%
09/02/09	4.67%	4.74%	4.72%	4.72%	4.72%	4.75%
10/02/09	4.57%	4.74%	4.69%	4.70%	4.70%	4.74%
11/02/09	4.56%	4.72%	4.65%	4.69%	4.68%	4.74%
12/02/09	4.54%	4.71%	4.64%	4.69%	4.66%	4.72%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
06/02/09	4.33%	3.70%	3.54%	3.68%	3.64%
09/02/09	4.32%	3.81%	3.84%	3.92%	3.95%
10/02/09	4.33%	3.89%	3.90%	4.02%	4.05%
11/02/09	4.28%	3.79%	3.79%	3.93%	3.91%
12/02/09	4.24%	3.68%	3.75%	3.91%	3.90%

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
06/02/09	6.59%	4.72%	4.48%	5.12%	4.78%	5.27%	5.04%	5.76%
09/02/09	4.75%	4.72%	4.38%	5.01%	4.68%	5.21%	4.95%	5.70%
10/02/09	4.74%	4.72%	4.39%	5.05%	4.69%	5.20%	4.96%	5.74%
11/02/09	4.74%	4.72%	4.53%	5.20%	4.84%	5.40%	5.07%	5.86%
12/02/09	4.72%	4.72%	4.53%	5.20%	4.84%	5.40%	5.07%	5.86%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/02/09	10/02/09	95.298	4.88%	2000	4020	1997
OK0711	09/02/04	11/07/25	88.631	5.02%	2200	1065	722
PS0413	09/02/04	14/04/25	101.935	5.31%	1600	1600	1186
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
06/02/09	39.00	34.25	31.25	30.50	8.25	8.50	1.40	1.40
09/02/09	38.00	34.25	31.25	30.50	8.25	8.50	1.40	1.40
10/02/09	37.00	34.25	31.25	30.50	8.25	8.50	1.40	1.40
11/02/09	37.00	34.25	31.25	30.50	8.25	8.50	1.40	1.40
12/02/09	37.50	34.00	32.25	30.25	8.25	8.50	1.40	1.40

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
06/02/09	3.5564	4.5634	-9.32%
09/02/09	3.5165	4.5475	-11.64%
10/02/09	3.4653	4.4774	-10.46%
11/02/09	3.4983	4.5318	-9.55%
12/02/09	3.4983	4.5318	-9.55%

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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