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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of February 19th to February 26th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Retail sales y/y	**Feb 24**	Jan	**1.9%**	0.7%	6.6%	Further drops of business activity indicators. Publications from other economies suggest that decent retail sales in January may be a global phenomenon.
MPC decision	**Feb 25**	-	**4.0%**	4.0%	4.25%	Although the real sphere gives more and more arguments for further rate cuts, depreciation of the zloty is likely to prolong the whole process and the final scale of the cuts will be lower than forecast even one or two months ago.

In Focus / Macroeconomics

Polish government steps in, announces the goal to enter ERM2 and … rescues the zloty

Rapid depreciation of the zloty has finally encouraged PM Tusk to comment on the possible exchange of EU money on the FX market. Additionally, he set an explicit intervention target for EURPLN at 5.000. The comment had initially seemingly limited market impact as the amount of EU money to be exchanged on the market was not high enough to fully balance the potential bids for euro from banks forced to unwind the currency options. Much more devastating for speculative positions (yes they are to be blamed for the most recent zloty weakness) proved to be ruling party representative Chlebowski comment on the quick ERM2 entry. Chlebowski pointed explicitly to the ongoing talks between the government and the ECB and that Poland is determined to entry the ERM2 even without reaching the political agreement before…And it was then when all the comments started to resemble a kind of strategy and pretty shocked the market so that the very limited intervention conducted via state owned BGK bank triggered almost 2.5% rally on the zloty.

Given the current situation on the FX, the announcement of the ERM2 participation should be seen as positive and stabilizing factor. There is another issue which put speculative positions in threat, though. ERM2 participation enables ECB to back the NBP in case of possible currency interventions, making thereby credibility (and automatically – effectiveness) of such an intervention higher. Note that an ongoing economic debate on costs of ERM2 participation in the times of economic downturn is not the center of focus and the market is starting to love the idea of exchange rate stabilization.

Turning to the euro adoption, it seems that the process May be a turbulent one. Fiscal policy (the general government deficit is to hit 3-4% of GDP this year) and inflation (Poland may face problems targeting the reference inflation rate amid deflation in the eurozone) are the main risks on the Poland's way to euro adoption.

As far as the short-term monetary perspectives are concerned, stronger or at least stable zloty is to create more room for monetary easing (it is however unlikely that the pace of monetary easing would resemble this priced in by the market few weeks ago). Furthermore, it is pretty unlikely that ERM2 participation would trigger any rate hikes soon and that the MPC would ignore the very negative momentum in the economy.

Economic downturn in progress…and gaining speed

The growth of employment fell in January to 0.7% y/y from 2.3% in December. It is worth to note though, that the scale of the deceleration does not fully reflect the softness of the labor market. Separate survey showed that the unemployment rate is likely to have risen in January to 10.5% from 9.5% in the previous month (it translates into 160k new jobless claims) and there is more anecdotal evidence on group lay-offs. In these circumstances the growth of employment was generated primarily by the revisions of the statistical sample (usual procedure in January). Had this revision been excluded, we might have witnessed an annual fall of employment close to 1.0%.

The search for a new equilibrium in the labor market is far from being over. In coming months, we expect job cuts to be massive (compared with 2001 slowdown, when job losses were gradual – as was the slide in economic activity) and 100k monthly cuts are within reach (this way the annual growth rate may gradually fall towards -5% in April), so is 12% unemployment rate. As we used to stress for long in our reports, the implications of faster job cuts are twofold: on the one hand they damp the consumer demand further and on the other they rapidly shape the bottom, the low-cost basis for recovery in 2H 2009.

As for wages, their growth rate in January jumped from 5.4% to 8.1% y/y. We are prone to suggest that seemingly low wage dynamics in December and the fast "recovery" in January are causally connected with shifts of remuneration (December's one paid in January) stimulated by the change on tax code (lower marginal rates since 1 Jan 2009) and have nothing to do with economic activity (and consumption in particular). We expect the growth rate of wages to fall to 3.0% y/y on the back of fast spreading economic slowdown and enactment of cost-cutting procedures in the majority of enterprises.

And indeed we experience a real slump in activity. Industrial output plunged by 5.8% m/m bringing the annual rate to -14.9% (the decrease in production exceeded market expectations at -12.4% y/y). Seasonally adjusted figure amounted to -12.7% y/y – the pace of contraction is very impressive and mainly driven by global economic slowdown. Sections with the most impressive production drops are indeed those exporting to the western Europe. The momentum of the economy is clearly very negative at the moment. Bringing together the prospects of sharp drop in employment and deceleration of industrial output gives a clear sign that Polish economy seems much more flexible and better posed to take its competitive advantage once the global economy rebounds.

Lower demand pressure generated by suppressed wage dynamics is a crucial element of inflation puzzle. So far, the CPI is trending downwards. Although January saw the index 3.1% higher than a year ago (and the extent of the fall was lower than widely expected), it was inflated mainly by the regulated prices – core inflation excluding food and energy is likely to have reached 2.6%. Further disinflation process may be, however, distorted by the movements of the exchange rate. The pass-through mechanism applies mainly to goods with relatively low demand elasticity, where firms can easily pass higher costs to consumers (natural candidates are fuels and food). Other goods (including tradables like wearing apparel, home appliances) are unlikely to start carrying higher price label so long as we witness low growth of purchasing power (and here lies the importance of low wage expansion). Summing up, there will be two opposing forces shaping up the CPI path: wage-driven disinflation and some pressure from dearer food and fuels. The first force is expected to take the upperhand – the disinflation process will be less rapid than previously expected, though.

As for the MPC decision, soft data support the dovish side of the body. However, it is the exchange rate development which weighs on the rate perspectives. So far the 25bp remains our call – so long as the MPC is uncertain on the mechanisms ruling the zloty depreciation it may refrain from substantial rate cuts in order not to accidentally make the market bleed again.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	4.8	**0.0**↓
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	**13.5**↑
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	2.9	**1.0**↓	**-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	**3.50**↑	**3.25**↑

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

Fixed Income

Tusk to the rescue.

Last week was rather volatile on the FI market. With PLN weakening to record levels bonds market turn to sharp sell of with rates moving towards 6% across the curve. FRA curve was pricing in most extreme moment only 25 bp cut. Sudden change in the sentiment came after PM Tusk statement about selling EU funds on the market and following “intervention” which moves exchange rate by almost 30 figures. Rates pushed down by 30 bp from the tops (2y IRS from 5.20 to 4.90). Economic release concerning PPI and Industrial Production didn’t influenced market at all as it gave mixed signal (according to our economic research core PPI is still pointing lower trend, but market will probably focus on headline figure). We believe RPP will cut next meeting, our bet is 50 bp. We also think rate cuts will be delivered probably in smaller steps in following months with repo rate going towards 3%. Big picture is not changing, moves done by Polish Government as well as support from EU authorities are pointing for buying time strategy. Having said that we see still value in holding short bonds, we also still hold our recommendation to keep short 1y3s.

RECOMMENDATION: Hold short bonds. Sell 1y3s.

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	2/23/2009	-	5.176%	2/16/2009
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

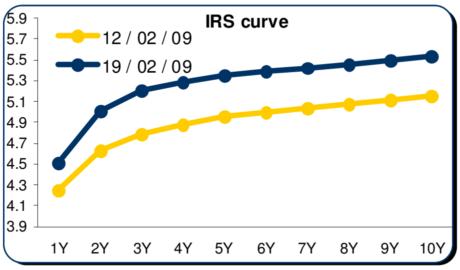
Surplus of the cash keeps liquidity out of problems

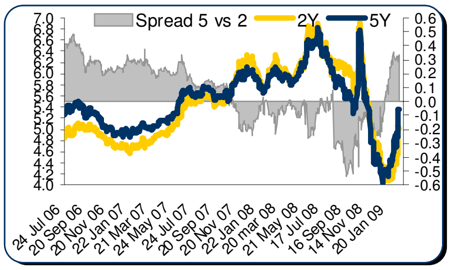
Currency is the key now

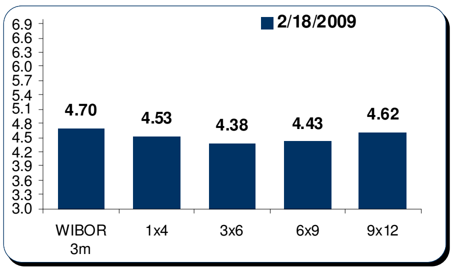
Liquidity still was not a problem. Nice surplus provides cash if needed pushing shortest rates lower and lower. Seems that we are approaching cheap end of the reserve.
Huge volatility for derivatives but turnover negligible. Small orders can move the price dozens of basis points. The direction is fully dependant on the currency movements. We end the week in far more optimistic mood after the government announcement about ERM2 plus small MinFin intervention. If the currency stays relatively strong, there still is a chance for some cut this month. However, the biggest odds are now for 25 bps step.

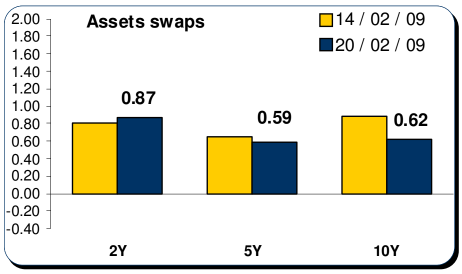
RECOMMENDATION: Sell 6,9M polonia if again above 3.5%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty mixed

This week zloty opened at 4.6245, touched high at 4.9300 and then strenghten toward 4.6400 on wave of P/T.

Implied volatility higher

Wakening of PLN was rapid, so vols went higher on flattened curve – 1M was traded at 33 whilst 1Y moved from 22 to 25.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.4000 / 4.9300
USD/PLN: 3.4000 / 3.9150

Short EURPLN

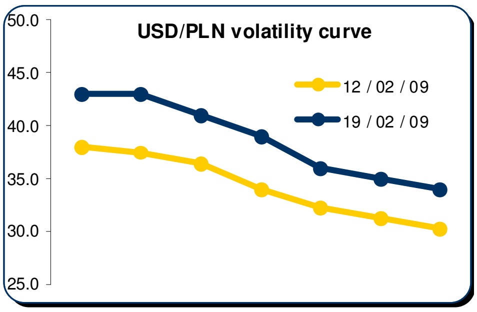
We have seen verbal/real MF intervention around 4.90. Although regional sentiment improved just a bit, market EURPLN long was partly reduced. We see opportunity to slip to 4.40 and below on closing rest of it.

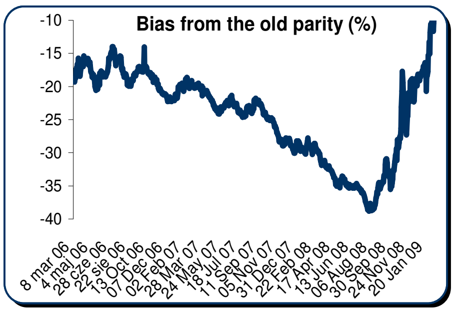
Short vega

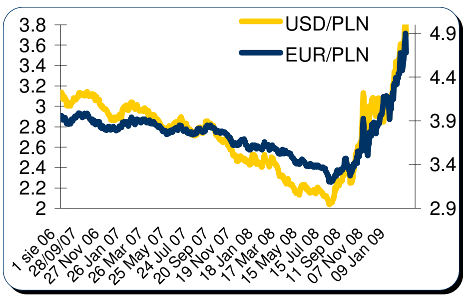
OPTIONS

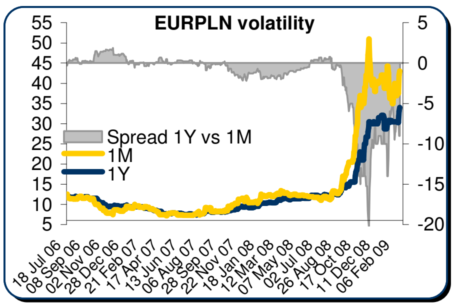
We believe in receiving some benefits from selling vega, especially 6M tenor.
For hedging we suggest buying KO options as it is cheaper due to barrier price on high volatility market.
Exporters may have some benefits from selling Risk Reversals as it is nearly highs (7 vols favour call).

FX CHARTS









MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)						
date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
13/02/09	4.54%	4.68%	4.64%	6.49%	4.66%	6.59%
16/02/09	4.54%	4.69%	4.65%	4.68%	4.66%	4.69%
17/02/09	4.58%	4.69%	4.64%	4.67%	4.65%	4.68%
18/02/09	4.56%	4.70%	4.64%	4.67%	4.65%	4.68%
19/02/09	4.55%	4.70%	4.64%	4.67%	4.65%	4.68%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
13/02/09	4.24%	3.68%	3.75%	3.91%	3.90%
16/02/09	4.24%	3.66%	3.72%	3.92%	3.84%
17/02/09	4.29%	3.80%	3.85%	4.11%	3.98%
18/02/09	4.33%	3.88%	3.93%	4.17%	4.11%
19/02/09	4.31%	3.85%	3.92%	4.12%	4.07%

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
13/02/09	6.59%	4.70%	4.55%	5.35%	4.88%	5.53%	5.07%	5.96%
16/02/09	4.69%	4.80%	4.74%	5.52%	5.05%	5.65%	5.25%	6.01%
17/02/09	4.68%	4.80%	5.06%	6.08%	5.35%	6.05%	5.53%	6.30%
18/02/09	4.68%	4.80%	5.01%	5.88%	5.35%	5.94%	5.53%	6.15%
19/02/09	4.68%	4.80%	5.01%	5.88%	5.35%	5.94%	5.53%	6.15%

PRIMARY MARKET RATES

Last Primary Market Rates	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/02/16	10/02/16	95.027	5.18%	1800	2142	1337
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
13/02/09	37.50	34.00	32.25	30.25	8.25	8.50	1.40	1.40
16/02/09	37.50	34.00	32.25	30.25	8.25	8.50	1.40	1.40
17/02/09	42.00	37.00	34.00	33.00	8.25	8.50	1.40	1.40
18/02/09	43.00	39.00	36.00	34.00	8.25	8.50	1.40	1.40
19/02/09	42.00	38.00	35.00	33.50	8.25	8.50	1.40	1.40

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
13/02/09	3.5949	4.6393	-7.68%
16/02/09	3.7360	4.7687	-6.29%
17/02/09	3.8238	4.8324	-3.44%
18/02/09	3.8978	4.8999	-3.74%
19/02/09	3.6952	4.6801	-5.33%

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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