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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of February 27th to March 5th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
MinFin's inflation forecast	Mar 2	Feb	**3.6%**	-	3.2%	Food prices diverging a bit from seasonal pattern on exchange rate developments and higher shipment costs connected with nearly 10% rise in automotive fuels. Next round of electricity hikes. Core inflation at 2.6%.
PMI	Mar 2	Feb	**39.1 pts**	-	40.3 pts	Downward tendency in new orders has stopped for a while. Current production and employment are still drowning, though. Consistent with this is monthly drop of PMI translating into further deterioration in business climate on annual basis.

In Focus / Macroeconomics

MPC cuts by 25bps, as expected

The repo rate stands now at 4.0%. As for the reasons behind the moderate decision, we bet on substantial zloty depreciation. Comments given just after the meeting confirm the MPC is still in easing mode and the rates will be adjusted to the fast changing environment. Apart from the dynamics of the economy, the zloty exchange rate is the center of focus.

The MPC statement is on the dovish side. The Committee points to negative spillover effects stemming from credit rationing and global economic slowdown. Data flowing from the labor market confirms the prospects for growing unemployment rate and falling dynamics of wages; both are to support easing inflationary pressure. The proposition finds corroboration in the fresh inflation projection. Central path of inflation is gradually falling towards 0.9% in 2011 going through 1.9% in 2010 and 3.2% this year. GDP growth also falters but the MPC expect it to recover gradually from 2010 on (the central path is locked at 1.1% this year, 2.2 in the following and 3.7% in 2011).

As expected, much attention was given to the zloty depreciation. With relation to the coordinated statement of CEE central banks issued some days earlier, the MPC stressed it is entitled to use instruments having direct effect on the exchange rate, which the MPC regards as undervalued. Pro-inflationary effects of the weaker currency were mentioned. However, once accompanied by some disinflationary forces embodied in higher valuation of consumers' liabilities, these effects does not seem to convey such a strong inflationary message. The MPC acknowledged the CPI inflation may be temporary elevated in coming months owing to the large swings in regulated prices (which apparently meets our assessment), though mid-term is likely to bring lower inflation.

Reading into the statement alone, it appears the MPC is ready to continue monetary easing process (what finds confirmation in individual rate-setters' comments). As the communiqué mentions clearly the "monetary easing" in future tense, we expect both the repo and deposit rate to be cut in coming months further; cuts in the latter may be sharper and asymmetrical with relation to repo, 0% including. We cannot rule ot the minimum reserve requirement ratio to be lowered as well in order to inject more liquidity to the system (so far the MPC awaits the results of research going along the lines of such actions).

As far as the next decision is concerned (25th March), EURPLN exchange rate will be of utmost importance. Although the temporary rise of inflation matches expected hump-shaped disinflation path expected by the MPC, higher inflation reading (3.6% y/y in February) may overly support the concerns voiced by the hawkish wing of the MPC (and spark discussion on the influence of the weaker currency again). On the other hand there is still a massive fall of business activity (toping nearly 20% y/y in terms of industrial output and nearly 1% in terms of employment) and almost undisputable fall of inflation in monetary policy horizon. Contracting economy support continuation of gradual easing and we would bet on another moderate (25bps) rate cut. The background for the decision is severely influenced by the exchange rate volatility, though.

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	**3.75↑**	3.25

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

Fixed Income

Another rate cut. Enough for a while?

MPC decided to cut rates by 25bp last week, according to the market consensus. Therefore reaction to the decision was very limited. As market seems to have reached some equillibrum level here we've decided to reduce our position in front end bonds and close receivers in 1y3s. On the one hand, MPC members reiterate that we're still in easing cycle and further rate cuts can be expected. On the other side we can expect bit higher CPI and PPI readings this month, which could put some pressure to the rates and put off next rate move. Also EURPLN rate could be consider as an obstacle for policy easing. Even though we are not strongly convinced for either direction for the rates, move up seems slightly more likely, which explains closing receivers. Position wise we've decided to stay neutral and look for clearer opportunities to enter.

RECOMMENDATION:

Close 1y3s. Reduce bond position.

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	3/2/2009	-	5.177%	2/23/2009
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

Restricted supply of money bills

Very cheap end of the reserve

All the rates down by 25 bps

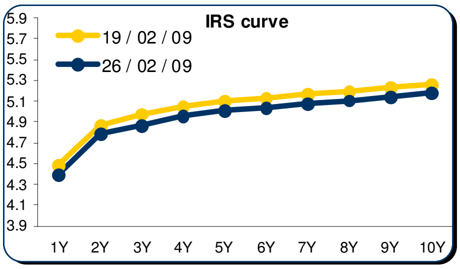
Extremely cheap week due to the slight change in the open market operation last Friday. Namely, the central bank decided to control the supply again. Therefore they offered 13.5 billion pln of money bills. Demand was huge at 26 billion pln; hence the reduction rate amounted to nearly 50%. Probably this change is meant to force banks to lend money on the interbank instead of the central bank. Moreover, the next step could be lowering the deposit rate or/and decreasing the reserve rate. Rationale for this strategy would be to flood the market with money and stimulate interbank loans plus maybe credit activity. Will it work? Yes, if only credit lines will show up and risk aversion disappear, and this certainly will not be the fast process. Therefore, we may expect some cheap carry for extended periods of time.

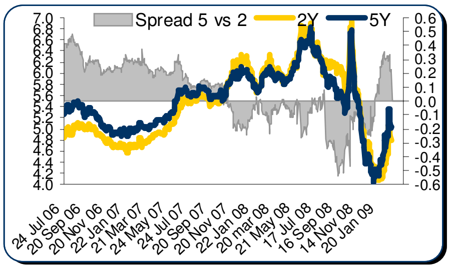
The MPC has cut all the rates by 25 bps. This was one of possibilities expected by players, however the least sophisticated one. However, taking into consideration the pln exchange rate, leaving the ammo for later, can be a very good idea. Next month the main rate may remain steady and the deposit rate can be cut. This would stimulate the interbank loan market, without harming the exchange rate itself in any part.

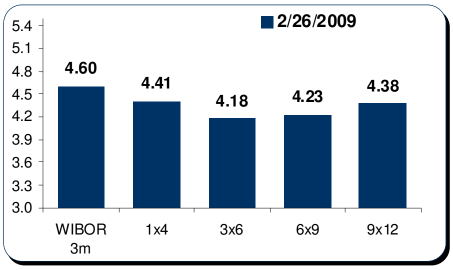
RECOMMENDATION:

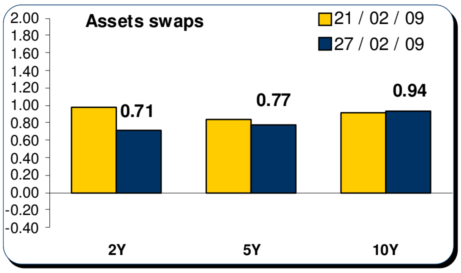
Sell polonia OISs on hikes.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty mixed

This week zloty opened at 4.6800 and was traded in 4.5600-4.7500 wide range. In the meantime we priced in variety of bad news for CEE, like outlook downgrades ect.

Implied volatility lower

Implied volatility curve opened at last week's levels and with relatively calm PLN market was traded softer at end of week, 1M moved down from 35.0 to 30.0 and 1Y from 25.0 to 23.5.

RECOMMENDATION:

SPOT

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

Short EURPLN

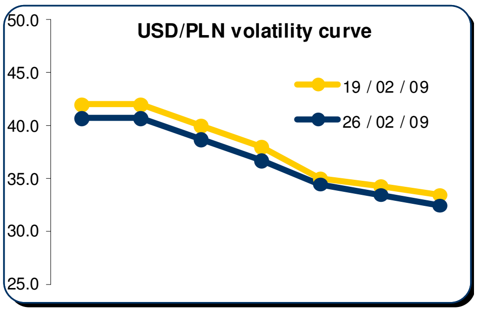
We still see room for PLN strengthening – 4.40 target. Sell at 4.80. Breaking of it brings 4.93 in play as testing level.

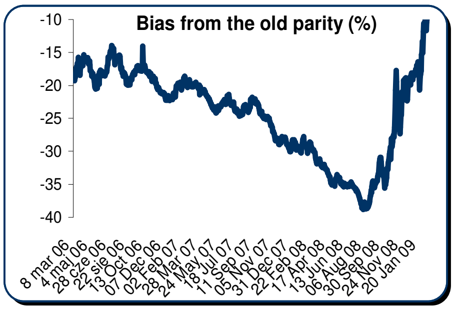
Short vega

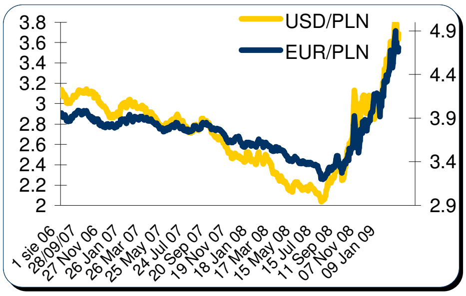
OPTIONS

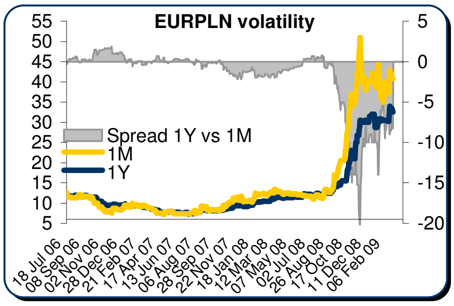
We believe in receiving some benefits from selling vega.
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.
Exporters may have some benefits from selling Risk Reversals as it is nearly highs (7 vols favour call).

FX CHARTS


USD/PLN volatility curve
19 / 02 / 09
26 / 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
20/02/09	4.54%	4.70%	4.65%	6.49%	4.66%	6.59%
23/02/09	4.53%	4.69%	4.65%	4.67%	4.65%	4.69%
24/02/09	4.48%	4.68%	4.62%	4.64%	4.62%	4.67%
25/02/09	4.49%	4.63%	4.57%	4.60%	4.57%	4.61%
26/02/09	4.40%	4.60%	4.59%	4.57%	4.59%	4.57%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
20/02/09	4.48%	4.23%	4.33%	4.53%	4.45%
23/02/09	4.53%	4.38%	4.43%	4.62%	4.58%
24/02/09	4.43%	4.22%	4.28%	4.48%	4.43%
25/02/09	4.43%	4.23%	4.33%	4.48%	4.43%
26/02/09	4.43%	4.18%	4.25%	4.45%	4.38%

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
20/02/09	6.59%	4.80%	4.90%	5.88%	5.11%	5.95%	5.27%	6.19%
23/02/09	4.69%	4.91%	4.83%	5.70%	5.04%	5.84%	5.20%	6.12%
24/02/09	4.67%	4.91%	4.80%	5.63%	5.03%	5.80%	5.19%	6.09%
25/02/09	4.61%	4.94%	4.79%	5.50%	5.01%	5.78%	5.17%	6.11%
26/02/09	4.57%	4.94%	4.79%	5.50%	5.01%	5.78%	5.17%	6.11%

PRIMARY MARKET RATES

Last Primary Market Rates							
	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/02/23	10/02/23	95.026	5.18%	1800	6960	2395
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
20/02/09	42.00	38.00	35.00	33.50	8.25	8.50	1.40	1.40
23/02/09	42.00	38.00	35.00	33.50	8.25	8.50	1.40	1.40
24/02/09	41.00	38.00	35.00	33.50	8.00	8.00	1.40	1.40
25/02/09	41.00	37.50	35.00	33.00	8.00	8.00	1.40	1.40
26/02/09	40.75	36.75	34.50	32.50	8.00	8.00	1.40	1.40

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
20/02/09	3.7823	4.7715	-5.98%
23/02/09	3.6592	4.7085	-7.39%
24/02/09	3.6602	4.6780	-6.37%
25/02/09	3.6312	4.6590	-4.70%
26/02/09	3.6869	4.7068	-3.99%

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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