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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, APRIL 17, 2009

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of April 17th to April 23rd

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Employment y/y	**Apr 17**	Mar	**-0.8%**	-0.8%	-0.2%	Business tendency indicators show the labor demand is falling further (anywhere besides manufacturing, where there are on record low levels). Group lay-offs continue.
Wages y/y	**Apr 17**	Mar	**3.2%**	4.2%	5.1%	Falling trend extended. Lower bonuses.
Industrial output y/y	**Apr 20**	Mar	**-9.9%**	-5.9%	-14.3%	Two working days more on annual basis. A kind of technical rebound from losses suffered at the beginning of the year. Better business indicators, positive signals from transport services. Better data on auto production skew the risk substantially towards higher reading.

Producer prices y/y	**Apr 20**	Mar	**6.0%**	5.8%	5.4%	Echoes of recent electricity hikes. Substantial growth of prices of copper (11%) and oil futures (19%).
Core inflation	**Apr 22**	Mar	**2.4%**	2.3%	2.4%	The slope of the core inflation trend remains negative. Some on-off factors connected with minor influence of exchange-rate developments.
MPC "Minutes"	**Apr 23**					

In Focus / Macroeconomics

Inflation temporarily elevated

CPI inflation rose in March by 3.6% on annual basis after 3.3% recorded in February (the reading was close to our forecast of 3.5% and earlier estimates of the Ministry of Finance). The 0.7% monthly rise stems mainly from food prices which – as we expected – diverged from seasonal pattern and climbed by 1.9%. Substantial rise of food costs bears some structural flavor (sugar deficit within the EU and undersupply of pork in the domestic market) and partially reflects the exchange rate developments (higher prices of imported fruits). It is worth to note that regional factors has pushed inflation (as measured by HICP) way beyond Maastricht inflation criterion which amounted in March to 3.6% whereas Polish 12-month average totaled 4.0%. As for the other CPI components, they were not surprising. According to our fresh calculations, core inflation excluding food and energy stayed at last month's level of 2.4% y/y.

Apart from some short-term upside surprises, the downward mid-term inflation trend remains intact and will not be an obstacle for another moderate (25bp.) rate cut, even this month. Although there were some hawkish comments from Noga and Wasilewska-Trenkner (they would rather stick to wait-and-see stance), dovish camp still seems to have a solid footing within the MPC. The best reflection of the MPC majority represents the swing-voter Czekaj, who speaks almost the same tone as even more dovish Pietrewicz. They both favor moderate cuts delivered in reply to deteriorating business activity, falling investment and employment – the so called mid-term perspectives on which, at least theoretically, MPC should primarily focus. We set the target for the repo rate at 3.25% during this easing cycle.

C/A surplus and IMF's FCL to lower Poland's risk

February C/A balance turned into surplus of 525 mln EUR after deficit of 1069 mln EUR a month ago. As for the breakdown, improvement in trade balance (-142 mln EUR vs -454 mln in previous month), huge inflow of EU funds (2.3 bn EUR in both capital and current account) related to pre-payment of funds within 2007-2013 financial perspective and reimbursement of funds connected with common agricultural policy was recorded. The data fully confirm our scenario we sketched a month ago which assumed that economic slump had encouraged domestic consumers and firms to considerably trim spending. As a consequence the spread between the growth rate of exports and imports widened (-4.8pp. vs -1.4 a month ago).

We see this trend to continue in coming months (further improvement in trade balance, continuous inflow of EU funds, negligible dividend payments etc.) as consumers and firms retrench further. Poland is vividly adjusting to a more sustainable trade deficit level given the broader theme of reduction of external imbalances globally. The situation we witness now does not adhere to standard crisis scenarios (as in case of Hungary which got the IMFs conditional assistance) and, turning to monetary policy, definitely allows the MPC to cut further, addressing deteriorating business conditions in the background of improving stability of Poland as a small open economy.

Another factor working towards reduction of Poland's risk was an announcement that the government applied for the IMF's Flexible Credit Line. Only a few weeks ago such a move was strongly dismissed by the FinMin, as no one was sure enough what the reaction of the market would be. As for now markets seems to fully understand the reasoning behind the new IMF's instruments and warmly welcomed Poland joining the exclusive group of EM countries eligible to obtain the FCL. The purpose of the credit line (estimated at 20.5 bn USD) is to increase the foreign reserves and secure foreign currency funding in case of another financial market squeeze and lower the risk premium in the Polish currency.

Improving flexibility of foreign currency funding accompanied by very rapid rebalancing of economy's external position are clearly working towards reduction of country risk. We think that Poland will not avoid a recession or at least a severe slowdown this year (we see GDP growth at 0.0% y/y) but it may well avoid problems with funding the state budget deficit (the natural choice would then be rather go long bonds than Polish stocks, as we do not see the company profits to skyrocket as in recent years, and banking sector cut on new credits for a prolonged period of time).

Fast growing budget deficit

Some time ago we wrote about advanced PR skills of the Ministry of Finance. Although the Ministry managed to positively surprise the market (the deficit in Q1 of 10.6 bn PLN versus 12.3 bn PLN), the composition of the budget balance does not leave much room for optimism.

Budget revenues amounted to 66.3 bn PLN (7% more than in the corresponding period of the last year) whereas expenditures totaled 76.9 bn PLN (22% more than in Q1 2009). On the revenue side we see a deceleration of indirect taxes growth rate (7.8 bn PLN versus more than 10 bn PLN a year ago) and sluggish expansion of personal income tax. Some positive news flow from the UE funds – as announced, absorption of these has been gaining speed. Moreover, we some sign of austerity measures and fiscal discipline on the expenditures side – substantial growth on this field reflects mainly obligatory flows on social insurance.

The strategic skills of the Ministry of Finance will be tested in coming months, as soon as flows on the revenue side enter the period of normalcy with no extraordinary flows. So far the anonymous sources quoted on Reuters explain the budget deficit may be marginally increased to 21 bn PLN. We do not exclude this to be only the first step, a kind of tuning the market for a larger move. Consumption slump and stagnation of wages may lead to a shortage of revenues amounting to 20 bn PLN. In this case even 10 bn PLN transferred outside the central budget is not enough to prevent budget bill from being amended in H2.

As for now the Polish government's strategy to buy the time and adjust the bond auction calendar to changing market sentiment seems to be quite successful. We see the speculations of a minor upgrading of the planned budget deficit fully coincide with this strategy. The government is clearly not willing to shock the market any time soon and prefer to wait till, say Q3 or Q4 when the markets definitely calm down, with the ultimate budget amendment. The heavy supply of (high yield) bonds may then, however, be met by foreign investors starving for better risk-reward.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	0.0	3.0
Inflation rate (%, average)	1.0	2.4	4.3	3.0	2.0
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-3	-2.5
Unemployment rate (end-of-year)	14.9	11.4	9.5	13.5	13.9
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.25	4.00

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	1.0	-0.5	-1.0	0.7
Inflation rate (%, average)	4.7	3.8	3.3	2.8	2.5	2.4
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.25	3.25	3.25

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

Fixed Income

Another good auction.

Most important event of the passing week was the switch auction, on which Ministry of Finance managed to place ca. 6bio bonds - quite an impressive amount. In first reaction prices fell by some 10-12bp, but shortly after returned to auction levels. The whole auction quite confirms our view, that risk appetite is growing, and such sell-off are simply good receiving opportunities. CPI data, slightly above consensus, shouldn't be a obstacle for further monetary policy easing, main risk we pointed to last week, i.e. budget deficit is a known issue and seems to be reflected in prices already. Although we still stick to our strategy of concentrating in front end of the curve, with preference for 2y bonds, as they present really good value and very low potential risks, we're becoming more eager to increase duration and build long bond position in 5Y sector on sell-offs.

RECOMMENDATION:

Keep 2y bonds. Add longer maturities on sell-offs.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.242%	3/30/2009
52 Week T-bills	4/20/2009	-	4.822%	4/9/2009
2Y T-bond OK0711	5/6/2009	-	5.615%	4/1/2009
5Y T-bond PS0414	5/6/2009	-	6.039%	4/1/2009
10Y T-bond DS1019	5/13/2009	-	6.224%	4/8/2009
20Y T-bond WS0429	5/13/2009	-	5.369%	1/14/2009

Money Market

Surprising OMO

Nice repo auction results

CPI higher then expected

Last open market operation was quite surprising. The central bank offered 18 billion pln of money bills, despite of the liquidity boosting policy (12 billion was maturing). It was around 2 billion pln too much to keep the market squared and probably connected with the lack of any treasuries auctions this week. Therefore, we think that tomorrow's OMO will be again amount-limited. This is not only our opinion, and the best proof is the fact that shortest rates moved only negligibly up this week. To sum up, cheap carry will be continued this month. Repo auction added net 2,8 billion pln to the system.

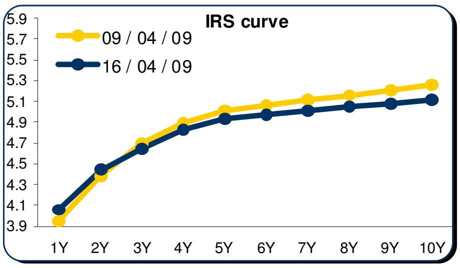
PLN may help another cut

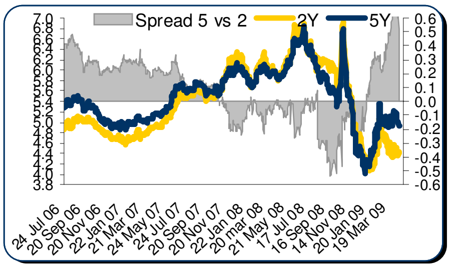
As for trading, 9 and 12 M tenors went up in yields. This is because some signals coming from the real economy this month. However, shorter rates remained low especially when polish currency strengthened so much during the last week (IMF standby line was the highlight). Hence both, doves and hawks have their arguments for another meeting. We see the probability to be 60/40 for another 25 bps cut this month.

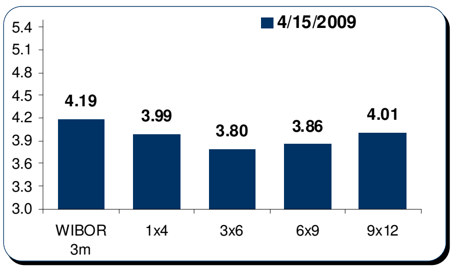
RECOMMENDATION:

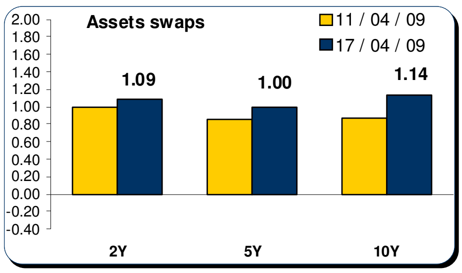
Sell 6m polonia at current levels.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

The combination of better investment climate plus the information that IMF has granted Poland credit line, had helped zloty gains. We briefly touched even 4.2250 the strongest zloty level till mid January. Now, we have to allow for some consolidation in 4.2000/4.3500 range. But we view 4.2650 as a pivotal level, with correction from this level to 4.50 or test of 4.0 being equally possible.

Volatility lower

With stronger zloty and calmer spot market, the implied volatilities were heavily offered. The 1 month EURPLN were traded at 20% and 1 year was offered at 19%. The currency spread USD/PLN against EUR/PLN was sold at 6.5% (it was 15 % in the middle of the crisis). The Risk Reversals were also offered.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4,2000 / 4.3500
USD/PLN: 3.1500 / 3.3000

Play the range

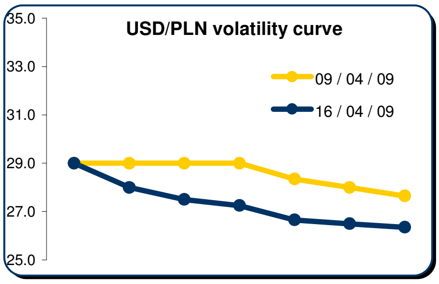
We will try to play the wider range 4.2000-4.3500 EUR/PLN with the short stop reverse at breaking neither 4.2000 or 4.3500 for a bigger move to 4.000 or 4.5000.

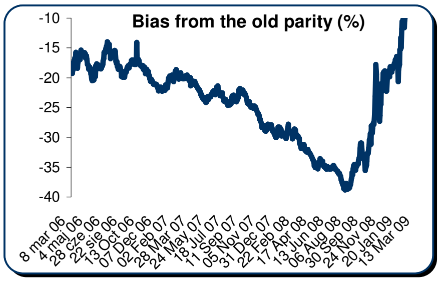
OPTIONS

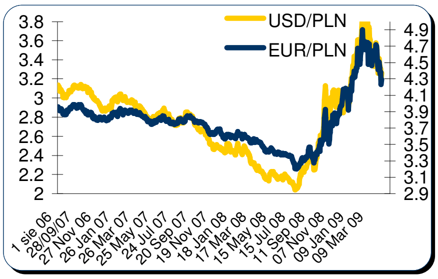
Sell spikes

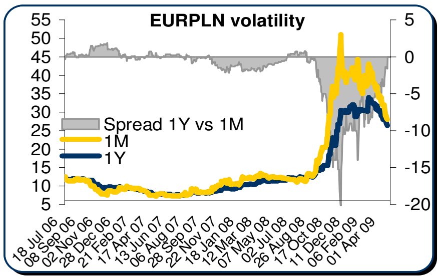
Although, we still believe in short Vega position in EUR/PLN and USD/PLN, but the fall in implied volatilities was quite substantial. We advice to take profit on the part of the position, and wait for any bigger spike to sell Vega again.

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
09/04/09	4.00%	4.14%	4.14%	6.49%	4.16%	6.59%
10/04/09	4.10%	4.15%	4.12%	4.17%	4.16%	4.21%
14/04/09	4.10%	4.16%	4.14%	4.18%	4.17%	4.23%
15/04/09	4.02%	4.19%	4.14%	4.19%	4.17%	4.24%
16/04/09	4.05%	4.21%	4.14%	4.21%	4.19%	4.27%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
09/04/09	3.97%	3.78%	3.82%	4.03%	3.98%
10/04/09	3.99%	3.82%	3.88%	4.10%	4.02%
14/04/09	3.96%	3.78%	3.80%	4.02%	3.94%
15/04/09	3.98%	3.79%	3.82%	4.04%	3.98%
16/04/09	3.99%	3.78%	3.81%	4.03%	3.97%

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
09/04/09	6.59%	4.85%	4.56%	5.61%	5.19%	6.00%	5.43%	6.27%
10/04/09	4.21%	4.85%	4.48%	5.56%	5.19%	6.02%	5.43%	6.25%
14/04/09	4.23%	4.85%	4.35%	5.50%	5.04%	5.99%	5.30%	6.22%
15/04/09	4.24%	4.85%	4.43%	5.54%	5.08%	6.00%	5.34%	6.23%
16/04/09	4.27%	4.85%	4.46%	5.43%	5.08%	5.94%	5.34%	6.20%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/04/09	10/04/09	95.351	4.82%	1500	5065	1961
OK0711	09/04/01	11/07/26	88.147	5.62%	2000	4384	2144
PS0414	09/04/01	14/04/26	98.748	6.04%	1500	2427	1514
DS1017	09/04/08	19/10/25	94.460	6.22%	2500	4846	1820

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
09/04/09	29.00	29.00	28.35	27.65	5.50	6.75	1.40	1.40
10/04/09	29.00	29.00	28.35	27.65	5.50	6.75	1.40	1.40
14/04/09	28.50	28.50	28.00	27.00	5.50	6.75	1.40	1.40
15/04/09	28.30	28.00	27.50	26.80	5.50	6.75	1.40	1.40
16/04/09	28.00	27.25	26.65	26.35	5.50	6.75	1.40	1.40

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
09/04/09	3.3388	4.4408	-5.62%
10/04/09	3.3225	4.3635	-3.24%
14/04/09	3.3019	4.3856	-3.87%
15/04/09	3.1946	4.2351	-4.74%
16/04/09	3.2628	4.2965	-8.22%

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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