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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of June 1st to June 4th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
PMI	Jun 1	May	**43.3pts**	-	42.1pts	Higher business tendency indicators abroad (mainly German Ifo) accompanied by stronger Polish counterparties.
MinFin's inflation forecast	Jun 1	May	**3.5%**	-	4.0%	Slowing momentum on food prices, moderate growth of fuels. Core inflation excluding food and energy at 2.6%, the last month's level (to be published June 22).

In Focus / Macroeconomics

Polish MPC holds rates, cuts reserve-requirement by 0.5 pctg point to 3.0%

MPC holds its interest rates at 3.75% but unexpectedly cuts the reserve-requirement rate to 3.0%. This move has been stipulated by the Polish banking sector since the beginning of the crisis and may be seen as the initiation of local sort of quantitative easing (aimed at increasing the liquidity in the interbank market). Although at the very moment reserve-requirement cut contrasts with the earlier comments of MPC members who pointed to ineffectiveness of such an action, it may be seen as a very cautious way of signaling a continuation of monetary easing in the months to come. Thus, we bet on bifurcation of monetary easing; the MPC is to resume interest rate cuts as soon as in June on the back of lower inflation projection and cut further the required-reserve rate to the level of 2%, suggested by MPC member Noga, this year.

Turing to the effects the reduced required-reserve rate it may have on the banking sector, the action is to increase the interbank liquidity by 3.5 bn PLN. It is doubtful, however, that the money will really boost bank lending. We rather see banks buying government debt and profiting from steepness of the yield curve. Such actions are going to subsequently translate into narrower asset-swaps.

In the mid term we see the slowing economy and weak domestic demand to limit the price pressures. Along with the widely echoed ultra dovish mood in the MPC itself it is going to result in interest rates falling to about 3.0-3.25%.

Q1 GDP growth at 0.8% y/y - much better than regional peers

GDP growth in Q1 amounted to 0.8% y/y which poses a positive surprise in the region (Poland is the only country with positive GFP growth). Growth decomposition is surprising, though, very surprising. The headline number was substantially affected by various revisions (stocks) and some strange behaviour of net exports contribution (huge divergence from historical pattern and our calculations).

Seasonally adjusted GDP posted 0.4% growth on quarterly basis (after 0.0% in Q4). We are quite skeptical towards this figure as it only weakly corresponds to the annual figure and earlier seasonally adjusted growth rates. We would rather see a 0.6% fall (SA q/q) and this better conforms with our model based on gross value added.

Q1 private consumption growth amounted to 3.3% y/y after 5.3% a quarter earlier. The deceleration of consumption seems obvious. However, quarterly data point to only a minor difference in quarterly growth rate of consumption between Q1 2009 and Q4 2008 (1.2% in Q1 versus 1.5% in Q4). On the other hand we witnessed a large fall of fixed investment growth rate from 4.6% y/y to 1.2% y/y (on quarterly basis there was a fall of investment close to 1%). Change of stocks was revised considerably lower. Fresh data suggests the process of inventory liquidation has started already in Q4 with contribution of the change of inventories at -2.9pp. (earlier data suggested only -0.6pp.). Simple algebra brought the contribution to 0.0% in Q1 then…Quite surprising is also the contribution of net exports at -0.1pp. It contrasts with our calculations based on *actual* data reported today (we still insist on a contribution of +2.5-3.0pp.) and the reported growth rate of internal demand (it is impossible for a country to have negative absorption, positive GDP growth and negative net exports contribution). Moreover, there was a trade surplus on nominal terms (almost 1.5 bn PLN) which fully confirms earlier quoted NBP data and the ongoing process of rebalancing (also in terms of the C/A). We bet on a substantial positive revision of net exports contribution in coming months.

On the supply side, softer quarterly dynamics have been recorded in the vast majority of categories. Industry dropped by 4.2% q/q SA and 4.9% y/y. Construction growth rate amounted to 3.7% q/q vs. +7.2% recorded in Q4 2008. Services and retail trade still display positive dynamics (4.4 and 5.6% q/q respectively).

<u>Conclusions:</u> As we noted in the last week's research note, a significant slowdown in private consumption and investment is to be expected as consumers being burdened by rising unemployment and lower wage dynamics will cut on durable goods spending. Falling capacity utilization rates along with more and more visible signs of overinvesting in industry and falling profits

are to severely weigh on new investments. Thus, the domestic demand will stay in the negative territory over the course of next quarters. The positive contribution from net exports and potentially positive impact of global recovery on exports-oriented sectors will be working towards higher GDP dynamics this year, close to zero per cent according to our forecasts.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	0.0	2.0
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	0.8	-1.0	-1.5	0.4
Inflation rate (%, average)	4.7	3.8	3.2	3.1	2.5	2.4
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.25	3.25

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

Fixed Income

Rates unchanged. Wibor higher.

While leaving rates unchanged, the MPC decided to cut obligatory reserve by 0.5%. Comments that followed were quite dovish. It seems that further moves depend on inflation perspectives. As may figure should be significantly lower than April one, also inflation projection will probably show CPI reaching target next year, further rate cuts can be expected. Question is if or when would that be reflected in Wibor rates, as these are constantly pushing higher. Such artificially elevated rates are becoming a concern for rate setters as well, it seems that cutting reserve is a part of set of actions that would bring Wibors to more realistic levels. Until that situation normalizes however, we still prefer cash instruments and OIS, as these are far more predictable. We didn't change our last week view, we're still positive for rates, especially in 2y sector, we sustain our long OK0711 recommendation, we also recommend receiving OIS in 6m-1y sector on all upticks.

RECOMMENDATION:

Stay long OK0711

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.456%	5/4/2009
52 Week T-bills	6/1/2009	-	5.076%	5/25/2009
2Y T-bond OK0711	6/3/2009	-	5.669%	5/13/2009
5Y T-bond PS0414	6/3/2009	-	6.039%	4/1/2009
10Y T-bond DS1019	6/10/2009	-	6.340%	5/20/2009
20Y T-bond WS0429	6/10/2009	-	6.340%	5/20/2009

Money Market

Very cheap end of the reserve

Extremely cheap end of the reserve requirement settlement period. Huge surplus of the cash in the system made shortest rates stay nearby the deposit rate at 2.25%. This was due to large inflow from maturing benchmark bond May09 along with its coupon, and unsuccessful trial of the CB to sterilize this inflow. They offered 24 billion pln of money bills, but due to their system breakdown and due to psychological trap of such an increase in the bills offered, market was risk averse and bought only 17 billion pln of the papers. Today's OMO is unable to change anything for this end of the reserve. The new one will be characterized by growing cost of carry to the main rate level.

The MPC cut the reserve rate, other rates unchanged

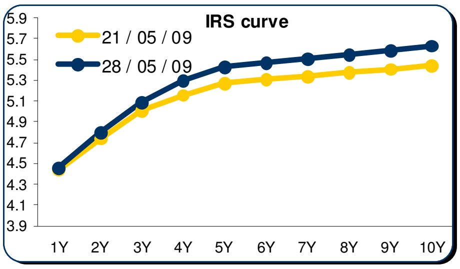
Growing wibor becomes an issue for the MPC

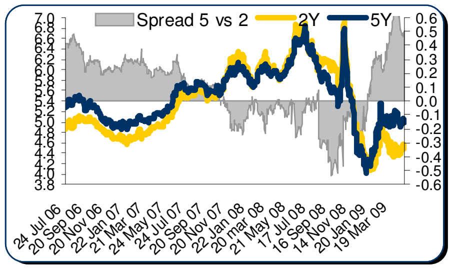
The MPC decided to leave all the rates unchanged. However, they cut the reserve rate by 0,5% from 3.5% to 3%. This will add to the system liquidity over 3 billion pln in July. The MPC motivated this move with growing wibor rates. Let us just remind that wibor rates started to grow when the CB suddenly changed its OMO policy (restricted supply, keeping market over liquid). They wanted to support interbank loaning and also credit activities. Being inpatient after 1.5 month they changed their mind (again sterilize the market to keep carry nearby the main rate), which was not the smartest move the CB could make. Lack of consequence after such a short period (banks would need around 6M to get credit lines back and to be sure that the CB's intentions are firm) resulted in a deep lack of trust. Adding volatility to a very thin market should not be the main activity of the CB. Therefore, it is very unlikely that the MPC will achieve its current goal after loosing majority of its credibility as far as liquidity management is concerned. Wibor rates have been growing mainly as a reply for the increased volatility (sudden change in OMO), pause in the easing of the monetary policy (the MPC), and willingness of some banks to close, as much as possible, the gap that exists due to the deposit war. The latter is a different story; there even is a view that some market participants are treated more favorably because of their more public character of the stake owners. But this is off screen rumor of course. Nonetheless, the score is 2:1 for the CB's share of growing wibor rates. Are they able to again convince the market for their aims? Unlikely in short term period, and as was stated above they are very inpatient.

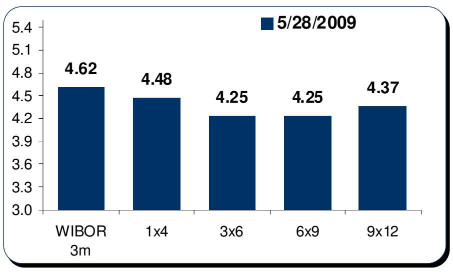
RECOMMENDATION:

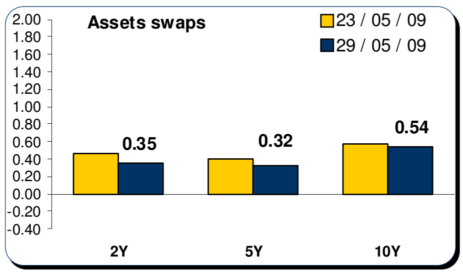
Buy 2W polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This week zloty has opened at 4.4400 and weakened to 4.5550 on Thursday's NY session. We saw worse sentiment all around the world. Reasons are: North Korea nuclear tests and anxiety present market optimism won't be followed by real data.

Implied volatility a bit higher

With every broken resistance we see curve a bit higher, 1M is traded at 20.5 (18 this week low) and 1Y at 17.5 (low at 17)

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.3800 / 4.6000
USD/PLN: 3.0000 / 3.3500

Stay away/Buy dips

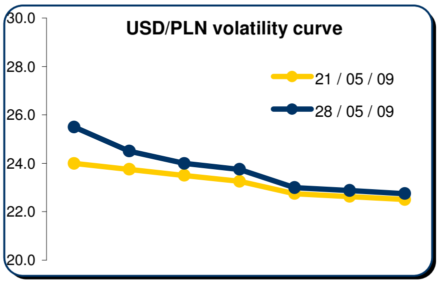
Zloty follows global equity play, we see high correlation with JPY crosses.
Polish GDP data should suggest amount of budget amendment on the local side.
We still see more risk on upside, lot of local resistance ahead of move.

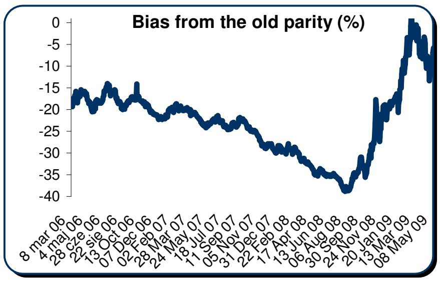
Sell vega on upticks

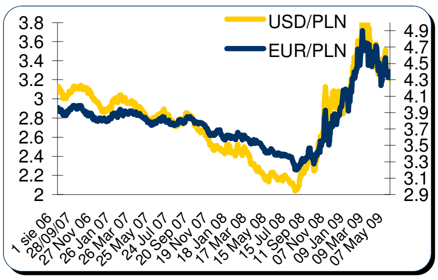
OPTIONS

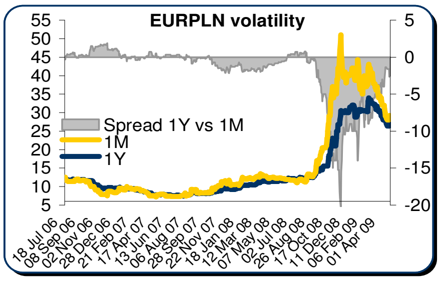
Vols looks a bit offered here, so we suggest wait for higher levels to entry short vega (20 vol for 1Y).
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.
Exporters may have some benefits from selling Risk Reversals as it is nearly highs (4.5 vols favour call).

FX CHARTS









MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M FXSW	3M WIBOR	6M FXSW	6M WIBOR	1Y FXSW	1Y WIBOR
22/05/09	4.43%	4.56%	4.55%	4.58%	4.84%	4.87%
25/05/09	4.44%	4.57%	4.54%	6.49%	4.84%	6.59%
26/05/09	4.43%	4.59%	4.55%	4.60%	4.85%	4.90%
27/05/09	4.47%	4.61%	4.50%	4.61%	4.87%	4.92%
28/05/09	4.49%	4.62%	4.57%	4.61%	4.87%	4.92%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
22/05/09	4.51%	4.30%	4.30%	4.43%	4.45%
25/05/09	4.51%	4.24%	4.24%	4.37%	4.43%
26/05/09	4.53%	4.27%	4.26%	4.39%	4.42%
27/05/09	4.53%	4.29%	4.30%	4.42%	4.46%
28/05/09	4.56%	4.29%	4.28%	4.42%	4.45%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y WIBOR	1Y TB	2Y IRS	2Y OK0709	5Y IRS	5Y PS0511	10Y IRS	10Y DS1017
22/05/09	4.87%	5.12%	4.82%	5.29%	5.37%	5.77%	5.53%	6.10%
25/05/09	6.59%	5.10%	4.81%	5.29%	5.36%	5.78%	5.53%	6.11%
26/05/09	4.90%	5.07%	4.86%	5.32%	5.46%	5.79%	5.64%	6.17%
27/05/09	4.92%	5.04%	4.84%	5.26%	5.45%	5.79%	5.61%	6.16%
28/05/09	4.92%	5.05%	4.80%	5.15%	5.43%	5.75%	5.63%	6.17%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/05/18	10/05/18	95.090	5.11%	800	1359	633
OK0711	09/05/13	11/07/25	88.602	5.67%	3150	5320	3313
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

date	USD/PLN 0-delta stradle 1M	USD/PLN 0-delta stradle 3M	USD/PLN 0-delta stradle 6M	USD/PLN 0-delta stradle 1Y	25-delta RR 1M	25-delta RR 1Y	25-delta FLY 1M	25-delta FLY 1Y
22/05/09	23.75	23.25	22.75	22.50	3.50	5.25	1.25	1.25
25/05/09	23.75	23.25	22.75	22.50	3.50	5.25	1.25	1.25
26/05/09	23.75	23.25	22.75	22.50	3.50	5.25	1.25	1.25
27/05/09	24.00	23.25	22.75	22.50	3.50	5.25	1.25	1.25
28/05/09	24.50	23.75	23.00	22.75	3.50	5.25	1.25	1.25

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
22/05/09	3.1543	4.4016	-11.50%
25/05/09	3.1578	4.4135	-11.05%
26/05/09	3.1948	4.4386	-11.32%
27/05/09	3.1714	4.4313	-9.42%
28/05/09	3.2418	4.4876	-9.32%

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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