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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of July 14th to August 20th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Corporate wages	Aug 18	Jul	**1.6%**	2.1%	2.0%	Solid negative trend on the most stable manufacturing. Lower bonuses and various wage arrangements drive the growth of average wage lower.
Employment	Aug 18	Jul	**-2.2%**	-2.3%	-1.9%	Stable or even better business tendency indicators. Government programs likely to support employment.
PPI	Aug 19	Jul	**3.6%**	3.9%	4.0%	Sharp fall of commodity prices. Further drop of price expectations supported by the zloty appreciation.
Industrial output	Aug 19	Jul	**-2.9%**	-3.8%	-4.3%	Upswing on the supply side continues, lead by the German economy. Far better business tendency indicators (mainly PMI).
Core inflation	Aug 20	Jul	**2.9%**	2.8%	2.7%	Core inflation negatively affected by excise tax and costs of lodging. We expect the core measure to stay elevated throughout 2009.

In Focus / Macroeconomics

C/A surplus widens

June saw another substantial C/A surplus amounting to EUR 459 mln versus revised 284 mln a month ago. Consecutive surpluses recorded in recent months lifted H1 C/A balance to EUR +1.1 bln – quite a stratospheric result compared with the corresponding period of the last year (EUR -10.3 bn). Improving current account owes much to EU transfers and considerable improvement on trade balance which has been thriving around zero in recent months.

EURPLN strengthening encouraged consumers to substitute foreign goods for the domestic ones and firms to trim investment activity. At the same time exporters manage to avoid losing the ground, supported by weaker currency and one-off cash-for-clunkers programs in western Europe. Those mechanisms caused imports to dip sharply (-31.8% y/y in June) and exports to fare relatively better ("only" -20.8% y/y in June), allowing trade deficit to shrink. It is meaningful to look at the quoted growth rates also in PLN. The relatively outperformance of exports looks then even more impressively (+6% in June) and is likely to support the financial standing of export-oriented firms. It is possible then that those companies will be better prepared to manage their costs and preserve employment (anecdotal evidence suggests some firms connected with automotive industry are even hiring employees at the moment).

We expect exports dynamics to improve further in coming months. Such a tendency will be supported by the upswing in the German economy (tendencies observed so far are likely to be intensified on the back of intra-industry trade tracking the global cycle). According to the fresh data, net exports in Q2 amounted to over PLN 3 bln. That is why we expect the foreign trade to contribute to the GDP growth even more positively than in Q1 – roughly about +3-4pp. Also the supply side data confirms the Q2 GDP reading will be better than previously expected (our official estimate is situated at 1.2%, close to the upper band of market forecasts). The same mechanism speaks in favor of better H2 GDP results, lead by the upswing in the German economy and the end of inventories correction. Recent developments also encourage us to sustain our earlier forecast that C/A balance to GDP ratio may close the 2009 at the "zero plus" level.

CPI inflation stubbornly high

CPI inflation surprised the market, this time to the upside, reaching 3.6% y/y in July after 3.5% in June (market consensus 3.4%, MF forecast 3.5%). Core categories recorded (once again the same story…) moderate growth, putting core inflation stubbornly higher at 2.9-3.0% in July.

Recent core readings do note bode well for (monetary policy relevant) 2011 inflation outlook. Although base effects are going to manifest themselves in full throttle in 2010 (inflation may then fall to 1.5% y/y), growth of prices on monthly basis may show inflationary processes escalating. Even right now, Polish inflation seems to be the odd one out in the region as other countries (mainly Czech Republic) experience gradual fall of core inflation. Such a behavior of prices puts the question mark over the alleged potential for some quarters of non-inflationary growth. It seems that Polish economy have not plunged enough in the recession territory to release strong disinflationary forces (mind the labor market and the relative strength of employment) and they are unlikely to fully spread their wings until the end of 2009. Owing to the recent very positive developments in the German economy, this may not happen at all as H2 may be marked by an upswing (first of all on exports and inventory correction) which is likely to be given additional boost from consumer spending in 2010…

The data does not change perception of monetary policy. We see the easing cycle over. What is more, faster than-expected monetary tightening seems also more and more likely (we would place a first hike in H2 2010). The scale of tightening may be substantial and the path of rates steep (the story non-inflationary upswing in 2010 is not convincing to us).

Privatization plans – further details

The government has finally accepted a plan which assumes privatization revenues will mount to PLN 36.7 bn in 2009-2010. Although the plan hinges on the outlines sketched earlier (February 2009), the speed of the privatization process was substantially boosted – originally proposed horizon of 4 years shrank to 18 months. Not only the speed but also the ways of privatization was changed. Without going into details (we advise the reader to look at official Treasury Ministry documents – to be translated into English soon), quite surprising is the plan to sell 10% stake in KGHM (roughly PLN 1.6 billion) and Lotos (no more than PLN 400 mln). The landmarks of the Polish privatization base on energy and mining sector: ENEA (PLN 8 bln), PGE (PLN 4.8 bn), TAURON (PLN 2.7 bn) and the rest of Bogdanka (PLN 1.9 bn). As for the other substantial sales there is Puławy and TPSA (both about PLN 800 mln). The government estimates the privatization revenue at 11.7 bn in 2009 and 25 bn in 2010.

Ahead of the privatization news the Fin Min announced T-Bill buyback auction. Although we do not contradict FinMin superior assessment of budget liquidity (it has already secured funding for more than 75% of its gross borrowing needs), the auction announced for August 19. was probably aimed solely at strengthening the positive impact of the privatization news. The maturity of asked bills (not exceeding October 7) suggest that the operation is not really designed to manage debt duration but rather to improve sentiment on the market. This maneuver may prove very important, as the bond issuance is to rise significantly in the near term (the government has to secure pre-financing for EU projects, which are to be refunded in Q1-Q2 of 2010).

We think that both buyback and privatization have some potential to support both the debt market (lower supply of bunds in 2009 and 2010) and the zloty (privatization may attract some foreign capital). Turning to the privatization plan, we think it is realistic, but we do not expect the government to sell all the stakes it intends to sell. First of all, the government may not be forced to apply the crisis like funding management in 2010 due to improving growth outlook (we will not be really surprised if the growth rates, on the back of German recovery, top 3% in 2010).

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	1.1	**2.0-3.0**
Inflation rate (%, average)	1.0	2.4	4.3	3.5	1.8
Current account (% of GDP, average)	-2.1	-4.5	-5.3	0.2	-2.9
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.8	13.5
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.50	**4.00**

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	0.8	1.2	0.8	1.6
Inflation rate (%, average)	4.7	3.8	3.2	3.7	3.4	3.5
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.50	3.50

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

Fixed Income

No positive surprise from CPI

Rates have been constantly climbing up for the past week in quite a fast pace. CPI data at 3.6% y/y surprised the market negatively and therefore slight correction of the last move didn't last long. It seems to us that current levels in the front end are quite neutral, with shortest FRAs trading at Wibor level and positive curve from 9x12 and on. CPI was the most important factor that could push rates lower again, but that doesn't seem happening now. Next month's reading will probably come out higher than this month, production data are also likely to surprise positively in terms of growth. It's really hard to expect further rate cuts in this cycle. We see significantly higher probability of higher rates in the near future than lower, we're happy to keep our pay position in front end and will be trying to add to that position on pullbacks.

RECOMMENDATION:

Stay pay 9x12 FRA and 2Y.

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	8/17/2009	-	4.168%	8/10/2009
2Y T-bond OK0112	9/2/2009	-	4.974%	8/5/2009
5Y T-bond PS0414	9/2/2009	-	5.550%	8/12/2009
10Y T-bond DS1019	9/9/2009	-	6.340%	5/20/2009
20Y T-bond WS0429	9/9/2009	-	6.340%	5/20/2009

Money Market

The central bank again adds volatility to the cash market

Cost of carry still low, however the central bank again started offering sufficient amount of money bills to square the market. This volatility that comes from changing strategy of open market operations is not what market needs nowadays. It is definitely the main obstacle to let the cash market regain trust and liquidity for periods other then overnight. Because the market participants never know what the central bank is going to do next time (just to remind two weeks ago they left huge surplus of the cash in the system), they focus only on shortest maturities. This definitely will not help the system liquidity. To sum up, tomorrow's money bills auction is one big unknown.

Falling demand for repo

On Tuesday we could observe falling demand for repo operations with the central bank. Banks decided to roll over only 500 mio pln out of maturing 3.2 billion pln. This is quite natural since the overall liquidity of the market is growing. It is the shortest liquidity thou but still traders prefer to finance their positions in cheap overnight, being aware of all the disadvantages comparing to longer term financing.

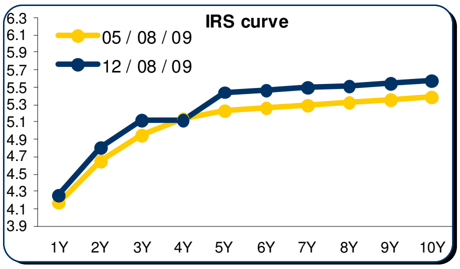
T-bills yields down during the weekly tender

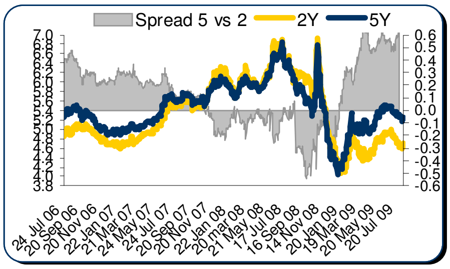
Benchmark T-bills average yield down at weekly tender from 4.22% to 4.17%.

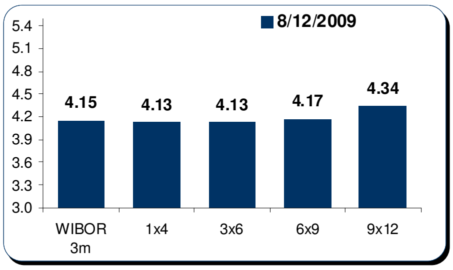
RECOMMENDATION:

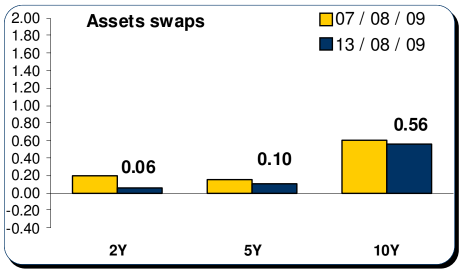
Sell 3m polonia at current levels.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in consolidation phase

This week zloty has opened at 4.0800 weakened to 4.2150 just to get back to 4.1100. Key to this move was FOMC monetary policy possible tightening.

Implied volatility bit higher

Realized volatility stays between 15-18%, it keeps short end curve high while zloty is finding new rend, 1M level is 15.5, 1Y's 14.25.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.0650 / 4.2700
USD/PLN: 2.8000 / 3.0600

Sell upticks

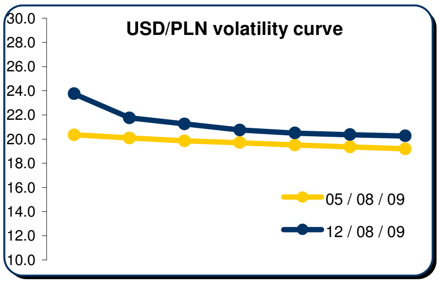
FOMC postponed monetary policy tightening, it keeps us still in 'sell upticks' mode, 4.30 is desired level.

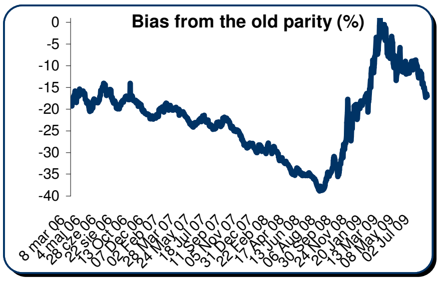
Sell gamma

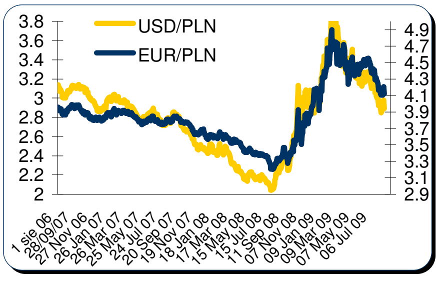
OPTIONS

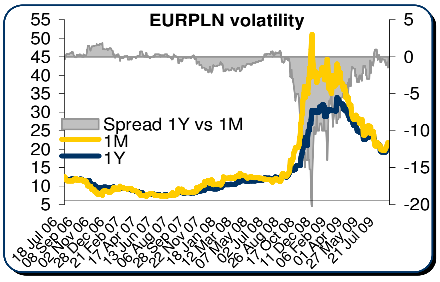
Curve is near this year low but we still see chance for short gamma trade to be profitable.
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.

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
06/08/09	4.06%	4.16%	4.23%	4.26%	4.37%	4.40%
07/08/09	4.00%	4.16%	4.25%	4.25%	4.42%	6.59%
10/08/09	4.03%	4.15%	4.25%	6.49%	4.40%	4.39%
11/08/09	4.00%	4.15%	4.25%	4.24%	4.37%	4.39%
12/08/09	4.05%	4.15%	4.25%	4.23%	4.40%	4.38%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
06/08/09	4.10%	4.02%	4.02%	4.15%	4.23%
07/08/09	4.09%	4.03%	4.03%	4.15%	4.25%
10/08/09	4.10%	4.04%	4.04%	4.15%	4.28%
11/08/09	4.10%	4.06%	4.06%	4.19%	4.28%
12/08/09	4.12%	4.06%	4.08%	4.23%	4.31%

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
06/08/09	4.40%	4.30%	4.66%	4.96%	5.24%	5.39%	5.39%	6.00%
07/08/09	6.59%	4.30%	4.70%	4.89%	5.27%	5.42%	5.41%	6.02%
10/08/09	4.39%	4.19%	4.74%	4.85%	5.33%	5.45%	5.48%	6.06%
11/08/09	4.39%	4.19%	4.81%	4.88%	5.41%	5.54%	5.56%	6.11%
12/08/09	4.38%	4.19%	4.81%	4.87%	5.44%	5.54%	5.57%	6.13%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	10 się 09	10 się 10	95.956	4.17%	1300	4218	1420
OK0112	09/08/05	12/01/25	88.708	4.97%	4500	11232	4502
PS0414	09/08/12	14/04/26	100.759	5.55%	3500	4967	3500
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
06/08/09	20.50	20.00	19.65	19.35	2.25	4.25	1.00	1.10
07/08/09	20.75	20.25	20.15	19.85	2.25	4.25	1.00	1.10
10/08/09	20.75	20.25	20.15	20.00	2.25	4.25	1.00	1.10
11/08/09	21.25	20.50	20.25	20.15	2.75	4.50	1.00	1.10
12/08/09	21.75	20.75	20.50	20.25	2.75	4.50	1.00	1.10

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
06/08/09	2.8728	4.1363	-16.21%
07/08/09	2.9021	4.1688	-17.31%
10/08/09	2.8921	4.1053	-17.19%
11/08/09	2.9165	4.1319	-16.47%
12/08/09	2.9795	4.2046	-16.52%

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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