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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 October 2nd to October 8th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
NO SIGNIFICANT RELEASES						

In Focus / Macroeconomics

Polish MPC changed the wording to less dovish

In line with our expectations Polish MPC kept the rates on hold (currently at 3.5%). Although the Committee is continuously concerned about the sustainability of the recovery, it's assessment of global and domestic economy is now upbeat a bit. Turning to inflation perspectives, the MPC noted that the economic slack has not yet neutralized the pro-inflationary effects of zloty depreciation or state-controlled price hikes. The already realized inflation inertia have probably led to MPC's less optimistic assessment of inflation persistence. Although the Committee still sees the inflation falling below the NBP target as the dominant risk in the mid-term, it stated explicitly that the likelihood of this to happen has diminished. We read this statement as a fine-tuning before the Committee change the bias to neutral at its October meeting.

At September meeting the Committee voted the monetary policy guidance for next year. It accepted discount credit as the only instrument to boost the credit growth. Governor Skrzypek also informed that the 1 year repo auction is to be postponed from November to Q1 2010. MPC rejected the NBP board proposal to recapitalize banks by buying banks issued bonds. The latter would be a move very similar to quantitative easing implemented by leading central banks... but will have happened a bit too late. We think any additional monetary easing in Poland coinciding with discussion on exit strategy in the core markets would probably result in aggressive rate hikes sooner than later.

Despite more hawkish statement, very likely change in monetary policy bias next month and super hawkish comments by most likely candidates to the new MPC (A. Bratkowski is pushing for rate hikes in H1 2010) we see some room for rate hike expectations to ease in the near-term. The real data with September PMI stabilizing at 48.2 pts and negative IP reading point to some momentum deceleration. We also see inflation edging lower a bit on the back of lower food prices (FinMin's already sees inflation to fall to 3.5% in September vs. 3.7% recorded in August; our forecast is even more optimistic). Additionally, several more moderate MPC members (Czekaj, Slawinski) expect inflation to fall below 2% next year and do not rule out further monetary easing.

We should emphasize that **despite more favorable short-term inflation perspectives (weaker momentum) we remain concerned about inflation momentum in the mid-term** (see tight labor market, high inflation inertia, massive controlled price-hikes and more and more likely credit acceleration next year) and think the MPC will have to hike rates in H2 2010.

2010 budget approved by the government

The government agreed broadly on the 2010 budget on Tuesday. Although the overall deficit level did not change, there were some gimmicks on the income and expenditure side which allowed the fresh project to better reflect the needs of some funds and ministries (almost accordingly to their earlier complaints). The government also accepted the new debt management strategy for 2010-12.

Compared to the earlier draft of the budget bill, either incomes and expenditures as well were revised upwards by PLN 3.4 bn. Surprisingly, such a trick was tracked down by some journalists at the press conference, but…turn down with a sour smile by Minister Rostowski. Further information concerning the budget bill revealed that the difference stems from moving some of the EU funds to the domestic budget, classified under the programs of technical assistance (such an operation is allowed by the new public finance bill, to be implemented in 2010). Moreover, such an action was quite easy to pass as the EU budget part had not been presented to the broad audience till then.

Turning to the debt management strategy it is striking the public debt will stay close to 55% threshold (the second among the 50%, 55% and constitutional 60%), reaching 54.7% in 2010, 54.5% in 2011 and 54.8% 2012. The Ministry of Finance may be then balancing on the edge of a knife. However, it should be noticed that it has a possibility of a very flexible debt management. First of all, the accepted macro forecasts are on the conservative side, in terms of GDP growth and inflation as well. GDP is expected to grow by 1.2% in 2010 and 2.8% in 2011 accompanied by benign inflation environment: 1.0% in 2010 and 1.8% in 2011. The recovery in the Polish economy is expected then to be only moderate, contradicting the stylized facts on the business cycle in emerging markets where slowdown/contraction is usually followed by quite a rapid expansion (we agree this time the expansion path may be flatter on world's structural problems, but not such sluggish). As for inflation, relatively strong labor market and stubborn core (of course along with possibility of a more rapid turnaround in GDP) pose significant upside risks to presented inflation path. Secondly, there is a EURPLN issue. Although the government forecast assumes PLN appreciation, it remains an important player on FX market and may control the valuation of the foreign debt (we remind the reader that the value of foreign debt for a given budget year is calculated in the year end). Thirdly, we also remind the privatization buffer – as far as we know the government remains very active on this field.

The bill has now entered the lower chamber of the parliament. Even when the debate is hot, the most crucial deficit level and financing issues are fixed. There may be some minor reallocations on the expenditure side, rather without (any) significant impact.

C/A quarterly statistics revised significantly down

The National Bank of Poland (NBP) revised the balance of payments statistics on Wednesday. Previously announced surplus in the C/A balance (PLN +890mln) was revised downwards to PLN -845mln. At the same time the errors and omissions account went considerably upwards by 1.3bn which nicely fits into C/A deterioration of 1.7bn. The for long heralded scenario of balance of payments adjustment have finally come true (although NBP official have stressed for long the statistics are just fine…).

There are more questions than explanations regarding the latest revision. First of all, it remains unclear whether the NBP improved the methodology of data collection, aggregation and processing and the ensuing publications will be less "bugged" or the revision stems from a standard procedure of recalculation, taking place each month (or quarter – with regard to the described data). (If we are experiencing the first case it may have implications for monthly data, in the other case – do not bother). Secondly, as there is no revision to growth rates of exports and imports, the revision must have affected the overall level of those aggregates within the whole time span – we may be then in another reality in terms of trade balance which will affect future readings downwards (final readings – but not necessarily the real-time data; rather official quarterly data than monthly provisional). Turning into the whole C/A balance, not once it happened the NBP corrected only the quarterly data and the monthly stuck just where they were…We cannot exclude such negative surprises in the future.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	1.1-1.5	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	-1.2	-2.9
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.3	12.8
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	1.1	1.2	2.7
Inflation rate (%, average)	4.7	3.8	3.2	3.7	3.5	3.6
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

Bullish …

Last week yields dropped some 5-15bp. across the curve. We saw continuation of trend which was initiated after announcing 1y repo operation by NBP. Curve flattened in 2y5y area, and was rather stable in 5y10y sector. Bonds got relatively cheaper to the curve and ASW curve steepened even further. The main event on the market was RPP meeting, bias was left unchanged, but market got some slight change in wording, making the comment sound less dovish. Price action forced us to take stop on 5y pay position, we still have 1y3s IRS pay position close to market level. Our opinion is that we are in range, with market currently looking for the bottom of the range, we don't expect last move to become a lasting trend. We still see risk on fiscal side not been included in prices, we think also that towards the year end carry trades may start to be unwind on larger scale, plus in October we will have a lot of coupon washing on all the DS10XX series. Open question is how much of the last move was related to end of quarter window dressing and 3y reference rate setting for open funds. Still, the strength of the market is quite surprising, at least to us.

TRADE IDEAS:

5y pay at 5.65 stopped at 5.40 (-25 bp loss); stay pay in 1y3s (opened at 4.45 currently at 4.40)

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	10/12/2009	-	4.397%	9/29/2009
2Y T-bond OK0112	10/7/2009	-	5.130%	9/2/2009
5Y T-bond PS0414	10/7/2009	-	5.550%	9/9/2009
10Y T-bond DS1019	-	-	6.340%	5/20/2009
20Y T-bond WS0429	-	-	6.300%	9/23/2009

Money Market

Last day of the quarter without turmoil

Just as expected the end of the reserve was extremely cheap with the deposit in the Central Bank growing up to 8 billion pln. We also survived the last day of the quarter without any major turmoil. Therefore, we can easily approach the new reserve with the shortest rates slightly below the main rate, and observe tomorrow's OMO to have a picture for the coming week. Implied probability from OIS curve strongly bets on another cheap month.

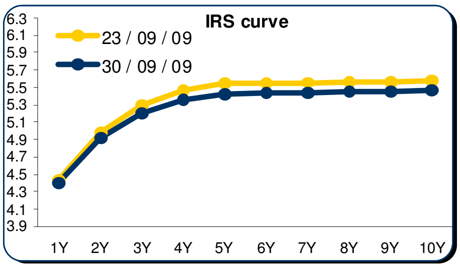
All the rates left unchanged plus extension to the trust pact

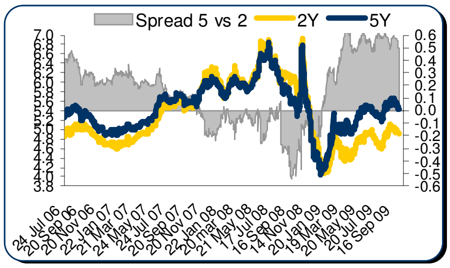
The MPC left all the rates unchanged, which was fully expected literally by everyone. Additionally they gave the green light for 12 month repo and the discount credit, but all next year. The idea with the bond own issues buy back from banks was rejected by the MPC.

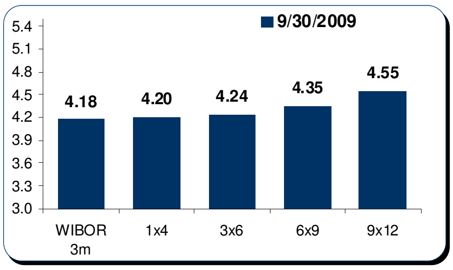
TRADE IDEAS:

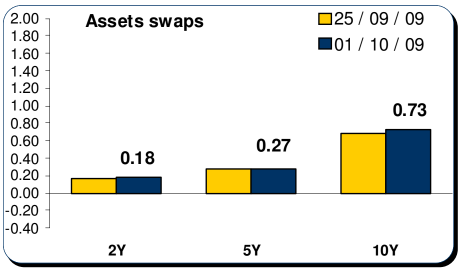
Sell 6M polonia

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This week EURPLN opened at 4.2200 and had been traded in 4.1900-4.2600. EUREKO compensation is most frequently telling story.

Implied volatility stays steady

While EURPLN is trapped in range, volatility curve stays pretty untouched. 1M is traded at 13.5, 1Y at 12.5.

TRADE IDEAS:

SPOT

Main supports / resistances:
EUR/PLN: 4.0650 / 4.2700
USD/PLN: 2.8000 / 3.0000

Wait if 4.27 hold

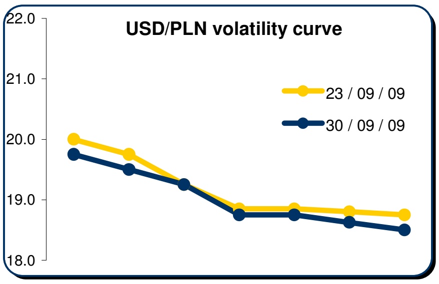
Zloty is trapped between Fibonacci levels 4.065 and 4.27. Market awaits outflow (between 4-10 bn PLN). We see here a lot of question marks and one fact market is long EURPLN. It convinces us to look for short EURPLN entry occasions.

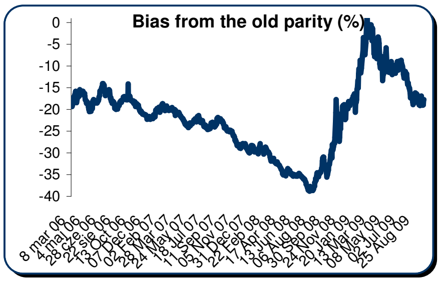
Stay away

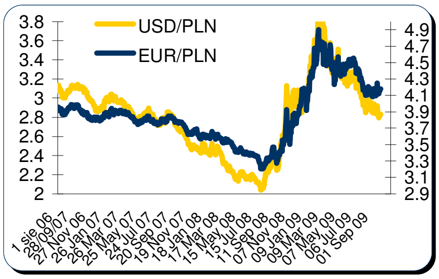
OPTIONS

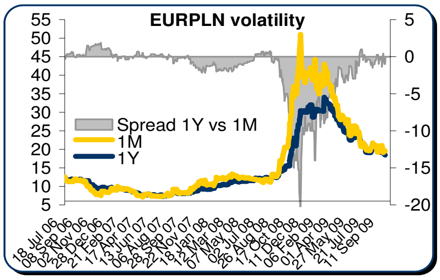
Wait for spot reaction. Selling gamma/vega if order turned rumour or will be done is next obvious move.

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
24/09/09	4.06%	4.18%	4.21%	4.22%	4.34%	4.38%
25/09/09	4.06%	4.18%	4.22%	4.23%	4.39%	6.59%
28/09/09	4.07%	4.18%	4.24%	6.49%	4.36%	4.39%
29/09/09	4.02%	4.18%	4.26%	4.22%	4.35%	4.39%
30/09/09	4.10%	4.18%	4.21%	4.23%	4.40%	4.39%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
24/09/09	4.20%	4.27%	4.40%	4.61%	4.61%
25/09/09	4.19%	4.25%	4.37%	4.57%	4.56%
28/09/09	4.20%	4.25%	4.38%	4.58%	4.57%
29/09/09	4.20%	4.25%	4.38%	4.58%	4.57%
30/09/09	4.17%	4.23%	4.35%	4.55%	4.55%

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
24/09/09	4.38%	4.30%	4.97%	5.08%	5.53%	5.78%	5.55%	6.18%
25/09/09	6.59%	4.30%	4.93%	5.09%	5.48%	5.75%	5.48%	6.16%
28/09/09	4.39%	4.31%	4.95%	5.11%	5.50%	5.73%	5.52%	6.16%
29/09/09	4.39%	4.30%	4.94%	5.09%	5.44%	5.74%	5.46%	6.17%
30/09/09	4.39%	4.32%	4.92%	5.10%	5.42%	5.69%	5.46%	6.19%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/09/28	10/09/28	95.743	4.40%	1000	2485	848
OK0112	09/08/05	12/01/25	88.708	4.97%	4500	11232	4502
PS0414	09/09/09	14/04/26	100.003	5.74%	2000	2159	1108
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
24/09/09	19.50	18.75	18.75	18.50	2.75	4.00	0.90	1.10
25/09/09	19.50	18.75	18.75	18.50	2.75	4.00	0.90	1.10
28/09/09	19.50	18.75	18.75	18.50	2.75	4.00	0.90	1.10
29/09/09	19.50	18.75	18.75	18.50	2.75	4.00	0.90	1.10
30/09/09	19.50	18.75	18.75	18.50	2.75	4.00	0.90	1.10

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
24/09/09	2.8309	4.1780	-17.67%
25/09/09	2.8309	4.1780	-17.67%
28/09/09	2.8309	4.1780	-17.67%
29/09/09	2.8309	4.1780	-17.67%
30/09/09	2.8309	4.1780	-17.67%

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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