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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 16th to October 22nd

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Wages y/y	Oct 16	Sep	**2.6%**	2.8%	3.0%	Within the trend. No difference in working days.
Employment y/y	Oct 16	Sep	**-2.4%**	-2.4%	-2.2%	Strikingly optimistic business tendency indicators (most of them in upward trend). Seasonal factors and some group lay-offs point to a more pronounced fall of employment (compared to last month). Perspectives positive.
Industrial output y/y	Oct 19	Sep	**-2.4%**	-2.4%	-0.2%	Better business tendency indicators although rising less swiftly. No difference in working days. Relatively good performance within auto production (Samar) in line with seasonal pattern. Expected better SA reading.
Producer prices y/y	Oct 19	Sep	**2.3%**	2.2%	2.5%	Relative minor movements in FX and commodity markets. Producer price expectations again at a positive level.
Core inflation y/y	Oct 21	Sep	**2.8-2.9%**	2.8%	2.9%	Estimate basing on exact figures point to an interval as much depends upon rounding. Core inflation stubbornly high, especially in this phase in the business cycle.

In Focus / Macroeconomics

Last week revealed more information on balance of payments developments and CPI inflation. The former partially confirmed earlier doubts on C/A surplus sustainability – although Poland experienced sharp rebalancing, owing to revisions we are now at a different level than was previously thought. On the inflation field, we learnt the downward movement in CPI is driven primarily by food prices whereas core inflation remains stubbornly high.

#1 C/A deficit narrows, meeting expectations

C/A balance came closer to zero in August and reached EUR -69 mln (after EUR -570 mln in the previous month). Substantial revisions occurred in the previous published data which amounted to cumulative EUR -2.2 bn this year (in line with the revision of quarterly statistics presented earlier this month). Revision is also present within errors and omissions account which was partially "distributed" among different C/A categories and as a consequence fell to EUR -352 mln from roughly EUR -1.4 bn at the start of the year. Official NBP estimates gradually gain in accuracy, however, 12-month cumulative errors and omissions are almost two times higher than C/A deficit versus the long-term average no higher than a half of C/A.

As for the breakdown of C/A balance, there was an improvement in trade balance (-481 mln with exports falling by 22.3% y/y and imports 26.9%) and current transfers (719 mln vs 277 mln last moth, to be attributed to huge inflow of current EU funds); income account deficit leveled off a bit on lower outflow of dividend payments to EUR 672 mln. As foreign direct investment turned to be considerably brighter (+890 mln vs -43 mln in the last month), the C/A deficit on 12-month rolling basis is almost 100% covered by foreign long-term investments.

C/A developments in the coming quarters are likely to be dominated by trade balance. Significant rebalancing experienced in recent months owes much to the compression of imports, negatively affected by consumer confidence and exchange rate developments. At the same time exports benefited from on-off fiscal stimuli ventured by western governments. Quarters to come are likely to be different. As the first-round effects of fiscal foreign measures wear off, Polish exports is likely to be driven more by intra-corporate trade and global cycle; such a developments are usually more import intense. Moreover, we believe that private consumption have reached a trough in Q2 and the revival process (although slow) has already begun (recent confirmation of this hypothesis came from budget performance: VAT revenues are trending higher). As for the other C/A components, we may see positive contribution in EU transfers as the government is seeking for extra income in the year end. Negative contribution may be reflected in income balance and dividend payments (with possible large lump sum in PZU-Eureko case). This year the C/A to GDP ratio is likely to reach -1.2% before swinging to -2.9% in 2010.

#2 September inflation again within the target range

CPI inflation hit 3.4% y/y, down from 3.7% in August, meeting our expectations. Food prices fell by 0.2% m/m breaking to the downside the usual seasonal pattern (and thereby resembling food costs behavior in other CEEs: Czech Republic and Hungary). There was also a relative large drop in fuel prices (-1.3%) and recreation and culture (-0.5%). Upward pressure was exerted by the costs of lodging (+0.2%), seasonal rises of wearing apparel (+1.7%) and education (1.1%). According to our fresh calculations core inflation is going to reach 2.8-2.9% (we quote interval as much depends upon rounding).

CPI inflation is likely to fall further in October, reaching 3.2% y/y on lower fuel prices and benign food costs developments. However, year end may see inflation once again running above the NBP range at 3.5-4.0% (mind the high elasticity with respect to food and fuel prices and upward base effects on the latter category). We may experience a severe drop of inflation in Q2 2010 when huge base effects from 2009 take their toll (substantial hikes of state-administered food prices and price effects induced by the zloty depreciation). It is worth to note though, that there is a risk of massive state-controlled price hikes at the start of 2010 as it is one way for local authorities to deal with income deficiencies.

Fresh inflation reading does not change at all the outlook for flat reference rate till the end of the MPC tenure (there should be a brand new MPC – apart form the governor – till February). However, we expect stubbornly high core inflation to prompt MPC to change the monetary policy attitude towards neutral in October, along with the fresh inflation projection (we heard slight change in wording already in the September statement). Although lower CPI data may somehow (and possibly temporarily) limit expectations on swift monetary policy tightening, rising momentum of price developments is likely to trigger rate hikes in H2 w 2010; the period of disinflationary growth in 2010 is likely to be a delusion.

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

Positive sentiment continues

Last week sentiment has been quite positive on the FI market. Yields move down by some 5-10bp across the curve, with 2y gaining the most (curve has steepened by some 3-4bp in 2y-5y sector). First auction of 'road bonds' attracted quite good demand, with bid/cover ratio above 3.5, the new IPS1014 was sold at some 30bp above POLGB's. CPI data (3.4% y/y), although slightly better than consensus didn't caused any significant reaction. Directionaly we still stay on the sidelines, however we start to consider thias rally as a bit overdone and if it continues, we'll be looking to pay on some dips (preferably below 4.80% on 2Y). We still like our FRA spreads that we entered last week (3x6 ag 9x12 and 6x9 ag 12x15); they haven't moved from our entry levels +30 and +50 respectively.

TRADE IDEAS:

Stay pay FRA spreads, pay 2Y at 4.80% or below.

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	10/19/2009	-	4.296%	10/12/2009
2Y T-bond OK0112	11/10/2009	-	5.115%	9/2/2009
5Y T-bond PS0415	12/2/2009	-	5.550%	10/7/2009
10Y T-bond DS1019	-	-	6.340%	5/20/2009
20Y T-bond WS0429	-	-	6.300%	9/23/2009

Money Market

Cost of carry remained low

The central bank offered 49.5 billion pln in money bills on Friday. This time all the papers were bought. Despite of the fact that the surplus of the cash was successfully sterilized, the shortest rates remained low and the short polonia oiss were still well offered around 2.5%. This shows quite a strong believe in a cheap carry at least till the end of the month. 3M repo also successful this month with the demand reaching 2.7 billion pln. Minimum repo rate unchanged at 3.75%.

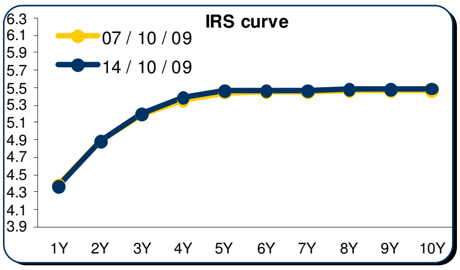
Bullish sentiment strengthened by the CPI and stronger currency

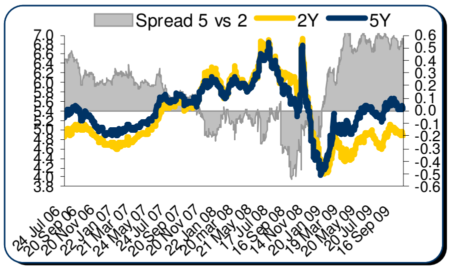
Slightly lower CPI figure then expected (3.4% vs 3.5%) has strengthened bullish sentiment; stronger currency was also very helpful. T-bills average yield has dropped by 11 bps during the weekly tender to 4.29%.

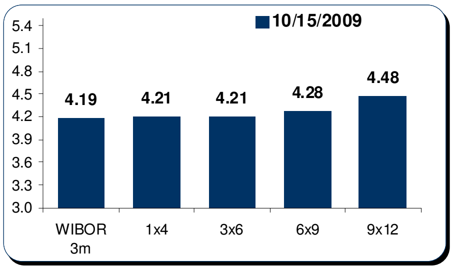
TRADE IDEAS:

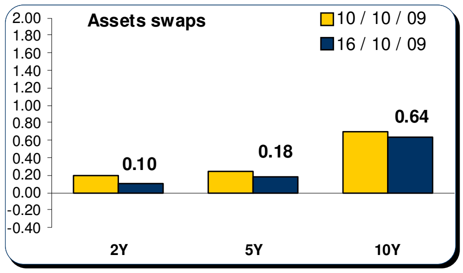
Stay receive on polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty in range

This week, the zloty has been moving in the wide range 4.1850/4.2950. Despite the generally good global sentiment, and the comment from Eureco authorities hinting that, they have already hedged their exposure, the zloty was not able to break the strong support at 4.1800. This inability of zloty, to get substantially stronger, makes us think that, maybe there is a big order to sell zloty still active in the market anyway.

Implied volatility - lower front end

As zloty is becoming more and more glued to 4.20, the front end of EUR/PLN volatility curve became offered (1 month given and offered at 14.00%, 1% lower then last Friday). The back end remained intact at 12.75% mid.

TRADE IDEAS:

SPOT
Main supports / resistances:
EUR/PLN: 4.1800 / 4.2950
USD/PLN: 2.8000 / 2.9500

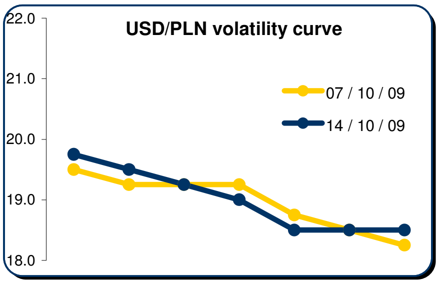
Hold PLN longs

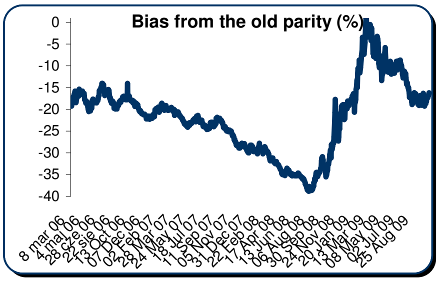
The picture is blurred, because of the possible zloty sell order being active in the market. We recommend to hold shorts in EUR/PLN from 4.2750 with stop above 4.3000 and profit taking at 4.07/4.10 level.

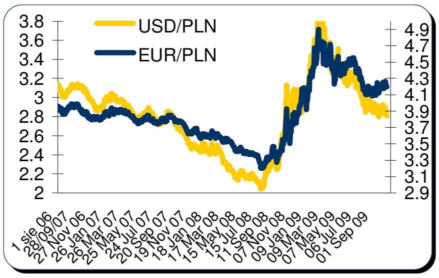
Hold short RR in the front end.

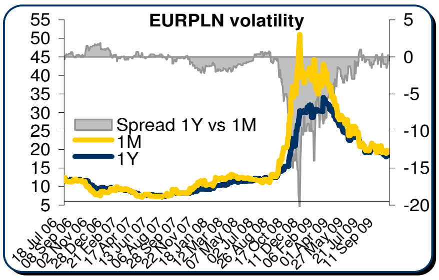
OPTIONS
We like the idea of being short risk reversals in the 1 week and 1 month period. It gives us nice long down-gamma with the positive theta bill .

FX CHARTS


USD/PLN volatility curve
07 / 10 / 09
14 / 10 / 09


Bias from the old parity (%)


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 FXSW	3M WIBOR	6M FXSW	6M WIBOR	1Y FXSW	1Y WIBOR
08/10/09	4.05%	4.18%	4.22%	4.24%	4.39%	4.39%
09/10/09	4.07%	4.18%	4.20%	4.23%	4.35%	6.59%
12/10/09	4.08%	4.19%	4.22%	6.49%	4.55%	4.40%
13/10/09	4.04%	4.19%	4.20%	4.23%	4.38%	4.39%
14/10/09	4.02%	4.19%	4.22%	4.23%	4.36%	4.40%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
08/10/09	4.20%	4.22%	4.31%	4.51%	4.55%
09/10/09	4.21%	4.22%	4.32%	4.54%	4.57%
12/10/09	4.20%	4.23%	4.32%	4.51%	4.55%
13/10/09	4.22%	4.23%	4.33%	4.53%	4.55%
14/10/09	4.21%	4.23%	4.34%	4.55%	4.56%

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
08/10/09	4.39%	4.35%	4.91%	5.11%	5.44%	5.71%	5.47%	6.19%
09/10/09	6.59%	4.36%	4.94%	5.14%	5.47%	5.72%	5.52%	6.21%
12/10/09	4.40%	4.34%	4.97%	5.13%	5.51%	5.73%	5.53%	6.21%
13/10/09	4.39%	4.34%	4.90%	5.10%	5.47%	5.68%	5.49%	6.17%
14/10/09	4.40%	4.34%	4.88%	4.98%	5.46%	5.64%	5.49%	6.13%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/10/12	10/10/12	95.837	4.30%	600	1962	409
OK0112	09/10/07	12/01/25	89.179	5.12%	4500	11890	4500
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

date	USD/PLN 0-delta stradle 1M	3M	6M	1Y	25-delta RR 1M	1Y	25-delta FLY 1M	1Y
08/10/09	19.25	19.25	18.75	19.50	2.75	4.00	0.90	1.10
09/10/09	19.75	19.25	18.75	19.50	2.75	4.00	0.90	1.10
12/10/09	19.75	19.25	18.75	19.50	2.75	4.00	0.90	1.10
13/10/09	19.50	19.25	18.75	19.00	2.75	4.00	0.90	1.10
14/10/09	19.50	19.00	18.50	18.50	2.75	4.00	0.90	1.10

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
08/10/09	2.8659	4.2351	-17.36%
09/10/09	2.8960	4.2640	-16.93%
12/10/09	2.8937	4.2602	-17.37%
13/10/09	2.8534	4.2215	-17.03%
14/10/09	2.8251	4.2090	-16.91%

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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