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FINANCIAL MARKETS DEPARTMENT

PAGES: 10

WARSAW, OCTOBER 22, 2009

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of October 23rd to October 30th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Retail sales y/y	Oct 23	Sep	**3.7%**	3.7%	5.2%	No working days effects. Decent car sales and business tendency indicators suggest the deceleration of retail sales is unlikely to be different than usual. Hence our quite optimistic forecast.
MPC decision	Oct 28	-	**3.5%**	3.5%	3.5%	Inflation within MPC target. Slowly improving real sphere. Inflation projection is likely to show slightly higher CPI and GDP path which may encourage the MPC to change the mood towards neutral.

In Focus / Macroeconomics

This weekly report covers two different issues. First of all we provide a brief review of recent macroeconomic data (industrial output, producer prices, wages and employment). They show the labor market stays relatively tight, manufacturing slowly accelerates and price pressures at the very beginning of the distribution chain remain contained. These data released were accompanied by quite dovish comments of MPC members. Next part of the report deal with inflation perspectives for 2010 and presents the main findings of our most recent research note.

Brief review of recent macroeconomic data

Labor market leveling off. September corporate wages came out above market consensus at 3.3% y/y vs. 3.0% recorded in August. It should be noted that the very pronounced downward trend in wages recorded in H2 2009 has been probably reversed as more and more sections of the economy have got to feel first signs of the recovery and labor market is likely to tighten again soon. Employment growth stabilized in September at -2.4% y/y and enterprise sector shed only 4k jobs on monthly basis (reading is the second best in the cycle). Such a circumstances can be truly named stabilization.

Labor market perspectives. In our opinion, labor market may prove much more resilient than in previous recession episodes. Such a situation may be linked to greater flexibility of enterprises (mind that the majority of jobs was shed in the very beginning of the slowdown, along with decent drop of sentiment) which allowed them to preserve profit margins. Also government programs contributed to contemporary situation by introducing flexible working hours (is seems enterprises exercised natural trade-off between working hours and employment in favor of the latter). Next months may bring more job cuts (end of seasonal employment in trade and construction, some lagged effects of group lay-offs) although a solid turnaround is on the horizon at the beginning of 2010 as the supply side expansion sets in (manufacturing). That is why we expect private consumption to have reached a trough in the current cycle already in Q2. The subsequent rise of the unemployment rate is unlikely to take its toll as it is related to the inflow of alumni, who – to be honest – does not alter their material status at all: they have been excluded from labor force and they will become unemployed (both cases entail no earnings). We are also skeptical as for the use of traditional keynesian consumption functions (relating consumption to the growth of disposable income alone) pointing instead to factor affecting expectations: relative stability of the labor market, rising consumer confidence and positive wealth effects.

Industrial production surprises on the upside. Industrial output dropped by 1.3% y/y in September beating analysts forecasts of -2.4%. Seasonally adjusted figure amounted to -2.1% vs. -3.1% y/y recorded in August. Declining output has been reported in 17 out of 34 sections. The pace of decline in automotive industry and metal branches, however, slowed significantly as compared to previous months. Today's data offset also a discrepancy between very optimistic results of the business surveys, with hard data lagging behind. Along with the newly released NBP report, including results of vast range of business surveys, the data on industrial production support the recovery view (having complete data set for the third quarter we estimate GDP dynamics as higher than those recorded in Q2, i.e. 1.1% y/y).

Construction still strong. September saw a 5.7% y/y rise in construction, much below the "holiday average" close to 10%. On the one hand, construction will remain a significant contributor to GDP growth. On the other, the headwinds for housing are getting more and more visible. We see a solid reallocation of resources from housing to publicly financed infrastructure construction. Such a developments should be considered positively in times of a slowdown as the state (together with the EU) provides a constant flow of funds; housing is likely to join later along with normalization in the credit market and further expansion of consumer confidence.

Disinflation still in full throttle. Producer prices once again surprised to the downside reaching 1.6% y/y after revised 2.2% in August. Ongoing sharp deceleration stems partially from a substantial revision of previous data and partially from hard-to-explain one-off factors (strange drop of energy-related categories). Moving away from month-on-month comparisons, core PPI (manufacturing excluding energy related goods) seems to have been relentlessly following the downward trend for some time (it fell from the 5.0% y/y peak in March to 0.4% in September). This fact corroborates the view of ongoing disinflation at the very beginning of distribution chain. We expect this trend to continue in coming months with additional variation added by commodities and exchange rate developments.

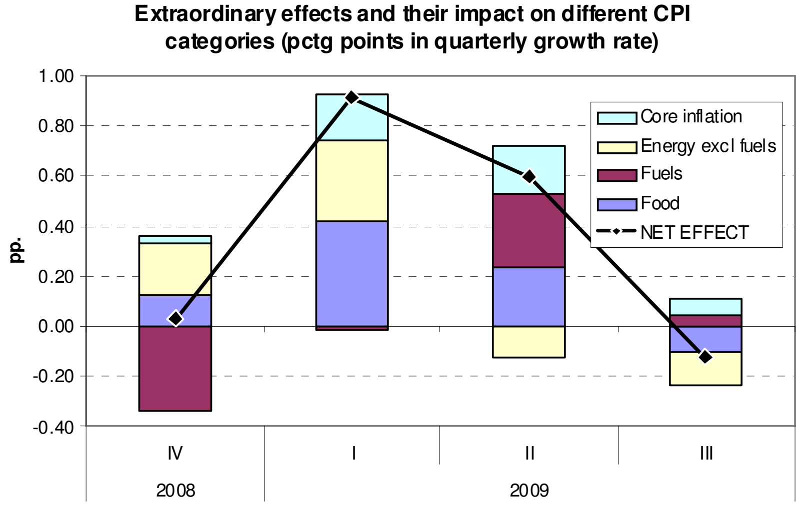
Statistical base effects to weigh on inflation in 2010

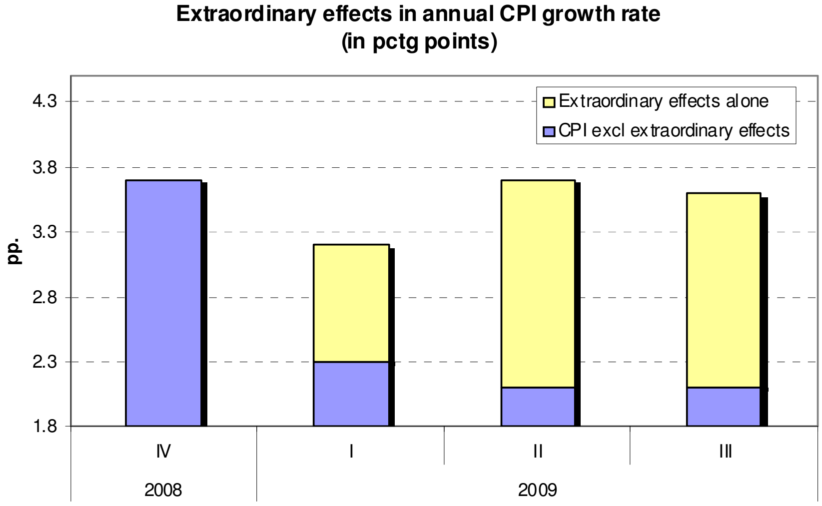
Although more and more analysts start to claim that base effects will be critical for next year inflation path, we have not really found a credible estimate of those effects so far. Strikingly, many analysts seem to improperly define those effects as being only determined by state controlled price hikes in Q1 2009.

In our opinion, Polish economy experienced some exogenous shocks this year (not only state controlled prices but mainly rapid zloty depreciation and abrupt changes in oil prices) and only a properly treatment of those can reveal a true statistical basis for 2010 CPI. We think the best way to solve the problem is to filter quarterly CPI variation in order to extract the contribution of shocks and the "normal" run of the time series. Our attitude towards looking for a true basis seems reasonable, as only identified shocks (as distinct from other effects connected with "normal" run of inflation processes) are unlikely to be repeated next year leading, ceteris paribus, to lower annual inflation.

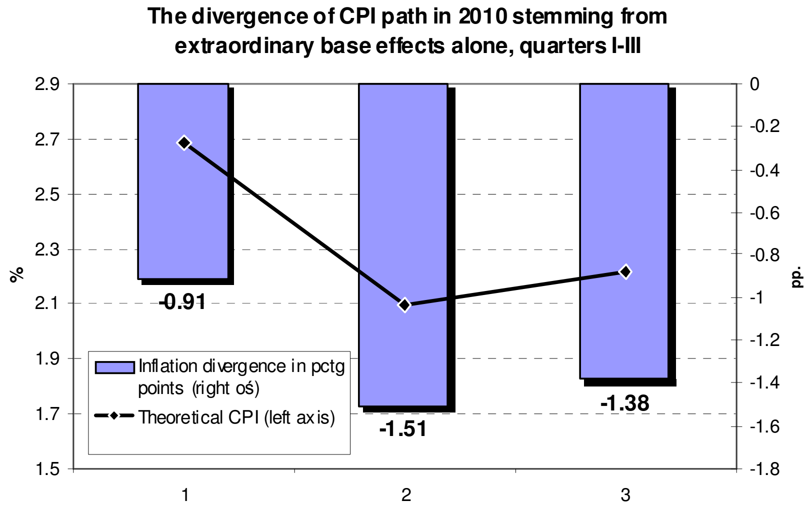
The size of extraordinary changes in CPI index has been estimated on the basis of econometric models explaining quarterly dynamics of the following subindices: fuels, food, core excluding food and energy, energy excluding fuels. Our models have 2 distinctive features. First of all, apart from accounting for different shocks transmitted via exchange rate and oil prices, they also track the co-movement of tradables' prices. Secondly, the models have partially autoregressive structure which helps to more accurately reflect the shock-propagation mechanisms (second order effects) in endogenous variables.

Obtained results show that shocks in different variables have different impact on CPI categories. However, the cumulative effect was usually positive leading to conclusion that the CPI inflation was somehow overstated by one-off factors. We present the main findings in the graphs below: first of all we plot a detailed breakdown of the impact of shocks on different CPI categories within quarterly growth rates; secondly, we also present the annual counterpart of those extraordinary effects, this time without detailed decomposition.





After the true base effects were established, we extracted the influence that exogenous shocks will exert on annual CPI index in 2010. They may lead to ceteris paribus decrease of the annual inflation rate by 0.9 pp in Q1 2010, 1.5pp in Q2 2010 and 1.4pp in Q3 2010 respectively, leading it likely below the NBP official target (we present those effects in the graph below, along with a theoretical CPI path in 2010 which stems from a neutral scenario: CPI at 3.6% in December 2009 and no shocks of such origin as in 2009).



Although the Polish disinflation is to be predominantly statistical in its nature, rate hike expectations – judging by historical standards – are set to evaporate in the months to come on the back of lower inflation readings. Yet inflation gaining momentum (measured by monthly growth rate of prices) on relatively tight labor market and economic recovery in H2 2010 is to reestablish expectations for more aggressive monetary tightening. We also remind the reader that the conducted analysis sketches rather the lower bound of inflation path – there is a high risk stemming from state-controlled prices which may be altered upwards by more than is commonly expected now. We rely here on a softening stance of price watchdog (URE) and relatively tough fiscal situation of local authorities which they may seek to revamp on the basis using regulated-price hikes.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	1.5	2.0-3.0
Inflation rate (%, average)	1.0	2.4	4.3	3.5	2.3
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	**1.7↑**	**3↑**
Inflation rate (%, average)	4.7	3.8	3.2	3.7	3.5	3.4
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

Nice rally in bonds but enough for now.

Last week we saw quite a nice rally on Polish bonds. We saw good demand especially in the middle part of the curve with. Wibor curve also shifted lower with 2y and 5y touching lows at 4.80 and 5.38 respectively. PS0414 made impressive 100 cents without any correction. The road bond auction went decent with prices close to 40 bp over bond curve (YTM close to 6.40) and good demand. It seems that temporary rally has reached its limit with switch auction and possible supply coming next week market prices may go lower a little bit. We see market stuck in range in 2y (4,80-5,00) and 5y (5,40-5,60) most likely we are at the bottom of the range so we are now tactically pay at 4.80 (recommendation from previous week) and looking to loose them close to 5.00 area (if we reach that level we think it will be good opportunity to receive). Flow wise we see it al very light and main theme is still steepening of the ASW curve. Looking a little further into the future according to our macro research we may experience period of quite sharp fall in yearly CPI figure which may bring CPI close to lower band of NBP target (close to 1.5% area), and it may last till late 3Q of 2010 (CPI staying below 2.5%). Therefore strategic position will be **buying 1,5-2y bonds**. They should be supported by macro data, 1y repo operation, and most likely zloty strengthening (period of low CPI will be accompanied with healthy growth in real economy). We favor short bonds also because they are cheaper option for foreign investors. With establishing bond position we are waiting for better valuations, likely when curve will hit the top of the range again.

TRADE IDEAS:

Hold FRA steepeners (3x6 ag 9x12 or 6x9 ag 15x18), stay pay in 2y (opened at 4.80 for 5.00, stop 4.70)

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	10/26/2009	-	4.260%	10/19/2009
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

Cheap end of the reserve inevitable

Quite a cheap week behind us with the surplus of the cash growing to 3 billion pln. It will definitely turn into very cheap end of the reserve due to the large additional inflow today (6M repo with the central bank settlement - 5.2 billion pln). We do not think this can be sterilized by tomorrow's OMO, especially that on Monday we have another huge inflow to the system. Almost 4.5 billion pln will be paid by the MinFin as coupons for DS series bonds. Therefore we are quite

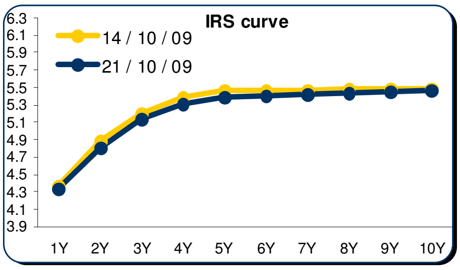
No reaction for last week's figures

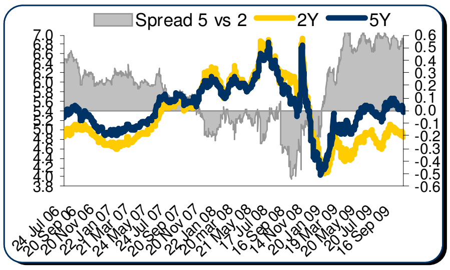
positive that shortest rates will be very near the deposit rate of 2% during the coming week. Last week's figures without the influence on money market. The curve more under pressure by the cheap carry then by PPI, IO or core CPI.

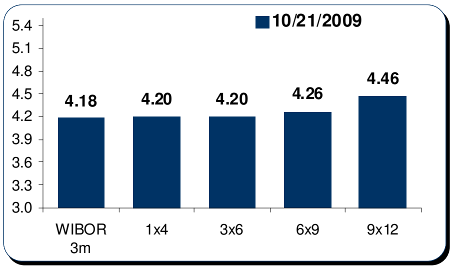
TRADE IDEAS:

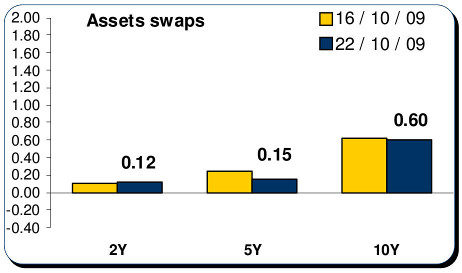
Sell 1Y polonia above 3.05%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger but traded same range

This week EURPLN opened at 4.1950, strengthen to 4.1500 just to weaken back to 4.2000 level. Probably, PZU dividend story and flow passed so Zloty again follows global/ regional sentiment changes.

Range trading around 4.2000 keeps vols at pretty same levels: 1M around 14, 1Y around 12.5.

Implied volatility stays steady

TRADE IDEAS:

SPOT

Keep short EURPLN

Main supports / resistances:
EUR/PLN: 4.0650 / 4.2700
USD/PLN: 2.7500 / 3.0000

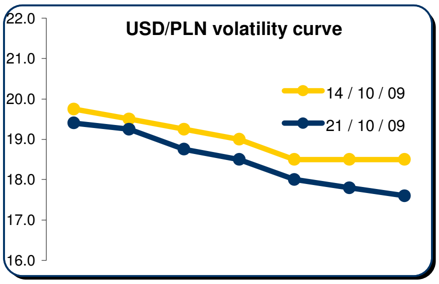
Zloty underperformed since dividend story begun so we see likehood of sharp upmove as low. We see 4.06 as target and breaking of 4.30 as S/L signal.

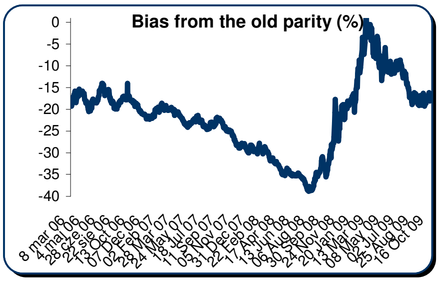
Sell vega

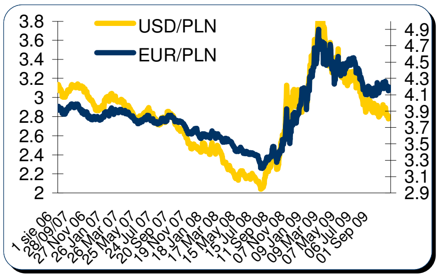
OPTIONS

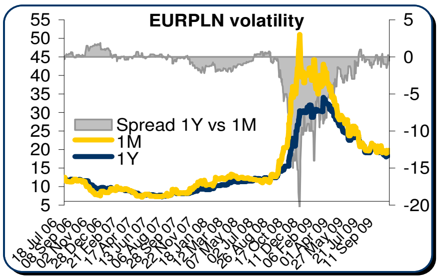
We like idea being short 6M 25D delta put. On other hand being short 1M/2M Risk Reversals should provide profitable gamma structure.

FX CHARTS


USD/PLN volatility curve
14 / 10 / 09
21 / 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
15/10/09	4.02%	4.19%	4.22%	4.24%	4.36%	4.40%
16/10/09	4.06%	4.19%	4.22%	4.24%	4.41%	6.59%
19/10/09	4.07%	4.18%	4.21%	6.49%	4.36%	4.39%
20/10/09	4.07%	4.18%	4.20%	4.23%	4.35%	4.39%
21/10/09	4.08%	4.18%	4.22%	4.22%	4.35%	4.38%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
15/10/09	4.21%	4.23%	4.34%	4.55%	4.56%
16/10/09	4.18%	4.22%	4.30%	4.50%	4.53%
19/10/09	4.21%	4.21%	4.28%	4.48%	4.51%
20/10/09	4.21%	4.21%	4.28%	4.48%	4.51%
21/10/09	4.20%	4.20%	4.28%	4.48%	4.51%

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
15/10/09	4.40%	4.24%	4.86%	4.99%	5.36%	5.61%	5.49%	6.11%
16/10/09	6.59%	4.32%	4.86%	4.96%	5.36%	5.60%	5.49%	6.11%
19/10/09	4.39%	4.29%	4.81%	4.94%	5.40%	5.56%	5.45%	6.09%
20/10/09	4.39%	4.28%	4.80%	4.91%	5.38%	5.52%	5.44%	6.03%
21/10/09	4.38%	0.00%	4.80%	4.92%	5.39%	5.54%	5.46%	6.06%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/10/19	10/10/19	95.870	4.26%	400	1825	400
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
15/10/09	19.40	18.50	18.10	17.75	2.25	4.00	0.70	0.95
16/10/09	19.40	18.50	18.10	17.75	2.25	4.00	0.70	0.95
19/10/09	19.40	18.50	18.10	17.75	2.25	4.00	0.70	0.95
20/10/09	19.40	18.50	18.10	17.75	2.25	4.00	0.70	0.95
21/10/09	19.40	18.50	18.10	17.75	2.25	4.00	0.70	0.95

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
15/10/09	2.8075	4.1958	-16.22%
16/10/09	2.8248	4.2078	-17.11%
19/10/09	2.8113	4.1988	-18.11%
20/10/09	2.7916	4.1759	-17.80%
21/10/09	2.7772	4.1518	-17.11%

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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