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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of November 6th to November 12ve

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A balance EUR	Nov 10	Sep	**-756mln**	-470mln	-69mln	More negative trade balance (exports falling by 23.7% y/y, import falling by -26.3% y/y), income account and current transfers (relatively low inflow of EU funds).

In Focus / Macroeconomics

Polish government to cut contributions to the privately managed pension system to curb rising public debt

Starting in mid-2010 Polish government will partially divert contributions from the privately managed pension system into a state-controlled account. Contribution to those pension funds, amounting currently to 7.3% of gross wages, is to be slashed to 3%. Remaining 4.3% is to be deposited on the state-controlled account and indexed at a rate close to that of government papers.

Such a move does not change the cross-generation liabilities but, according to public finance methodology, helps to reduce budget deficit (by PLN 13bn yearly due to lower contribution directed from public finance sector to pension funds) and public debt (by about 1% of GDP) in the years to come. It will thus naturally translate into lower borrowing needs as well. One has to note, however, that privately managed pension funds were a natural and most stable source of demand for government papers (they were obliged to invest at least 60% of their assets in low risk papers) so the net effect (balance between demand and bond supply), assuming no changes in their investment strategy, will not be greater than 3-5bn per annum.

Diverting contributions from pension funds to state controlled account has this advantage that it improves fiscal indicators and reduce the much feared risk of breaching 55% debt to GDP threshold. We see it as one among other measures – e.g. possibility to increase issuance of foreign bonds, ambitious assets sales and IMF's flexible credit line – to limit the budget liquidity risk and the risk of sky-rocketing borrowing needs.

Making use of "crisis-strategies" of the sort mentioned above, wrapped additionally in issues concerning efficiency (the Ministry claims reducing pension funds fees is aimed at improving pensioners welfare, not to limit budget deficit and debt) makes fairly good impression. The Ministry has definitely also another emergency exit in case the above mentioned are not enough. There's been some rumors concerning the temporary abandoning the self-imposed debt ceilings (50%, 55%) in order to prevent fiscal tightening in the very beginning of economic upswing (by the way, such a rationale was recently praised by central bank governor Skrzypek). Such a strategy was already demented by the Finance Ministry (it is a natural way of probing the market reaction). However, we cannot exclude a scenario in which the government uses this "tool" as well. Of course, the announcement of this quite controversial measure will be "sold" by the Ministry along with a definitely positive news concerning the plan of reform and consolidation of public finance in the mid term.

International institutions and rating agencies would definitely not love such a toying with a budget and debt numbers and abandoning the much priced pension system reform (along with possible fiddling with debt ceilings). We think, however, that a risk of Poland's downgrade as it is the fastest growing EU economy, is still very limited.

Summing up, Polish government definitely risks losing investor confidence as it fails to implement real fiscal reforms at a time when regional peers took more serious steps to close the budget gaps. The confidence "crisis" is very unlikely to be a severe and prolonged problem and - judging by this year's experiences - investors very quickly refocus their attention on other issues. We think that lowering gross borrowing needs (and consequently reducing the size offered at the successive bond tenders) is likely to be a psychological factor supporting Polish bond prices in the mid-term.

We shall remind the reader that the above-mentioned changes in pension law are in their very early stage. After the multilateral negotiations within various ministries, they must be approved by two houses of Parliament and signed by the President.

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	**12.0↓**	**12.5↓**
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	1.1	1.7	3.0
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 changes from the last release with arrows showing the direction of changes

Fixed Income

About the budget, borrowing needs and OFE

Last week was saw very little volatility. After touching highs of what we think is range (4,80-5,00 in 2y and 5,40-5,60), the market is trading a little above upper band (2y at 5,04 and 5y at 5,65). Market got some pretty good news about CPI (Ministry of Finance is expecting 3.1% yoy), but the reaction was rather tame. Road bonds were sold again with good demand and average price close to 40bp above government bonds. The highlight of the week, though, was the news about lowering pension fee that will be transferred from state budget to OFE (Open Pension Funds). Idea got very cold reception by market participants, and we see risk that international community may be taking this news relatively negative. Our opinion is slightly different. We were underlining several times that government is working on many exit strategies (let;s call them fuse strategies) in case budget situation is worsening. We already have conservative assumptions towards growth and CPI embedded into budget (both if surprise on the upside will be positive for revenues); second is liquidity “pillow” that Ministry of Finance is building - currently standing at 33 bio PLN (2/3 in euros), third one is that already 96% of borrowing needs is secured for 2009, so coming switch auction will be lowering borrowing needs for 2010 (last switch auction drew 4.5 bio demand). Coming JPY issue will most likely serve the same purpose. Right now we have OFE restructuring which will save (despite long term impact) 13 bio PLN. And do not forget about the IMF facility if things are to get very bad. Summing up, we are not enthusiastic about the shape of public finance, but it appears to us that the Ministry of Finance has upper hand, and historically looking they have been very efficient with their debt strategy (in the beginning of 2010 Ministry of Finance will have “fuse” of about 50-60 bio PLN not adding FCL facility to “play” with). What would make us change the view is if Tusk started losing in polls ahead of elections or lack of plan of fiscal consolidation after the presidential election (or around that period) in case he wins one. Therefore we don’t see significant risk of debt selling off, and if it happens, we may change our strategy from short bonds, into longer tenors.

TRADE IDEAS:

Hold 2y bonds.

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	12/7/2009	-	4.223%	10/26/2009
2Y T-bond OK0712	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

No T-bills auction this month.

CPI projection did not thrill the market

Shortest rates well below the main market rate. Polonia fixings below 3%. Tomorrow's open market operation again around 60 billion pln, and we bet the next week should also be cheap. If this scenario happens, the probability of another cheap month grows.

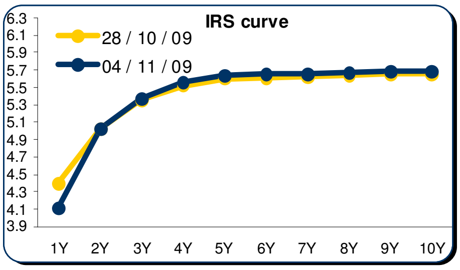
No T-bills auction this month, only the buy-back one on 23rd.

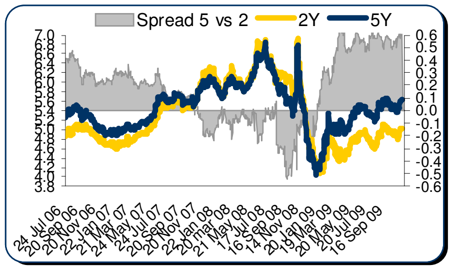
Market still sleepy and without any vigor. Slightly better then expected CPI projection (3.1% vs 3.2%) without any significant influence. FED and ECB decisions did/will not surprise also.

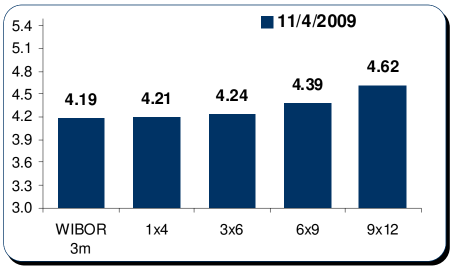
TRADE IDEAS:

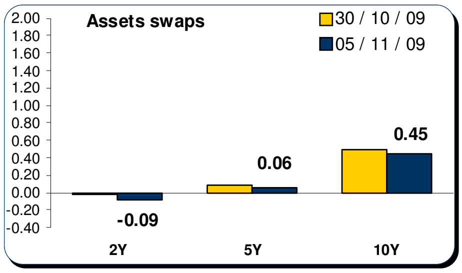
Sell short polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

At the beginning of week, zloty was weaker due to CEE3 outflow orders. Important 4.30 level had been broken but the move was not followed by the further risk appetites reductions. The market has cleared the 4.30 stop-losses, and market positions are now much lighter. We started the week at 4.25, reached 4.32 high and corrected to 4.2400 mid range after series better than expected US figures. Highest correlated crosses are, beside obvious CEE3, EURUSD and EUR-JPY.

Implied volatility higher

As usual, the EUR/PLN volatility curve was mimicking the developments on zloty. We have seen higher volatility with softer zloty and then better offers along the curve, while the zloty was re-covering. Short end of the curve was relatively stable i.e. 1M in 13% -14.5% values but we have observed healthy demand for longer term interests – 6M was paid at 13.2% and bid at 13% .

SPOT

TRADE IDEAS:

Main supports / resistances:
EUR/PLN: 4.1500 / 4.3700
USD/PLN: 2.7500 / 3.0000

Keep short EURPLN

We still like the idea of being short. Stop-losses at 4.3000 were cleared during the US time zone. While the improvement in global sentiment took us back, below key level at 4.3000 once again. We would like to re-enter the short EURPLN position. Because the economy is doing well and macroeconomics forecasts are being revised up. So although the price action around 4.30

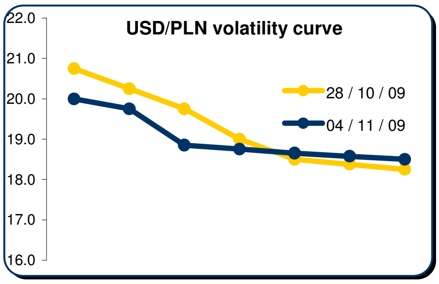
gave us mixed signals we are the sellers at 4.30 with S/L 4.38 and P/T 4.0650.

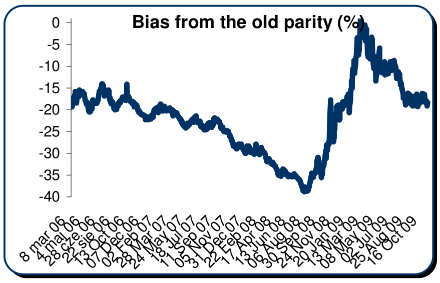
Sell vega

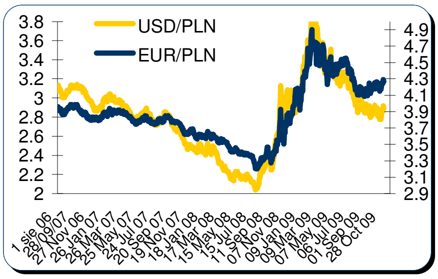
OPTIONS

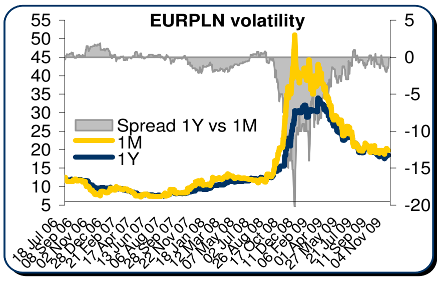
We thing the implied volatility has risen too much in the comparison to the jump in historic volatility. We like the idea of being (modestly) short Vega and Gamma at current levels i.e via Short 2 mth ATM (includes Christmas) or short longer term puts to have also positive Vanna.

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
29/10/09	4.06%	4.18%	4.15%	4.21%	4.34%	4.37%
30/10/09	4.09%	4.18%	4.21%	4.20%	4.39%	6.59%
02/11/09	4.06%	4.18%	4.21%	6.49%	4.37%	4.38%
03/11/09	4.10%	4.19%	4.21%	4.21%	4.38%	4.38%
04/11/09	4.09%	4.19%	4.17%	4.21%	4.40%	4.38%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
29/10/09	4.19%	4.20%	4.27%	4.48%	4.52%
30/10/09	4.19%	4.21%	4.29%	4.50%	4.54%
02/11/09	4.20%	4.26%	4.28%	4.49%	4.56%
03/11/09	4.20%	4.23%	4.39%	4.61%	4.59%
04/11/09	4.21%	4.23%	4.37%	4.60%	4.61%

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
29/10/09	4.37%	4.43%	4.98%	5.02%	5.59%	5.70%	5.63%	6.16%
30/10/09	6.59%	4.43%	5.00%	4.98%	5.60%	5.68%	5.63%	6.12%
02/11/09	4.38%	4.42%	5.02%	4.97%	5.62%	5.65%	5.64%	6.11%
03/11/09	4.38%	4.43%	5.02%	4.97%	5.63%	5.67%	5.65%	6.14%
04/11/09	4.38%	4.43%	5.03%	4.94%	5.64%	5.70%	5.69%	6.14%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/10/26	10/10/26	95.905	4.22%	500	1758	431
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	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
29/10/09	20.10	19.15	18.65	18.50	3.25	4.50	0.80	0.85
30/10/09	19.85	19.15	18.65	18.50	3.25	4.50	0.80	0.85
02/11/09	19.85	18.65	18.65	18.50	3.25	4.50	0.80	0.85
03/11/09	20.00	18.85	18.65	18.50	3.25	4.50	0.80	0.85
04/11/09	19.75	18.75	18.65	18.50	3.25	4.50	0.80	0.85

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
29/10/09	2.8847	4.2540	-17.90%
30/10/09	2.8595	4.2430	-18.16%
02/11/09	2.8767	4.2500	-18.65%
03/11/09	2.9195	4.2907	-19.10%
04/11/09	2.8908	4.2662	-18.28%

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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