Bank Zachodni WBK

Weekly economic update

27 October – 2 November 2008

While the situation in money markets overseas and in the Western Europe seems to be gradually stabilising, which is reflected by slight decrease in money market rates, world stock markets are still in panic mode amid high risk aversion and recession fears. Emerging markets saw a dramatic deterioration in moods and sell-off last week. Even though bad news were related to neighbouring countries, including Hungary and Ukraine, Polish currency and bonds suffered heavily from the investors' flee from the region. In the near term, it will be moods abroad and information from neighbouring markets that will be key determinants of zloty and bonds' behaviour. In situation when market is driven by emotions, it is hard to predict exchange rate movements, especially in the short run. Option market is pricing in further sharp increase in zloty volatility, which shows that investors are afraid of continuing depreciation. In case of more negative news from emerging markets, such scenario is possible, and level 4.0 versus euro may be tested again. If this level is breached, the next important threshold is 4.13. A factor that may potentially help in improvement of attitude towards Polish assets is the government's decision regarding agenda of euro zone adoption. The question is whether confirmation of government's determination will be enough to improve sentiment or if the market will rather wait for signal that cooperation with opposition is possible. The MPC decision on Wednesday will be in our opinion obscured by market situation, especially as we expect no change in interest rates. In our view, the MPC could change the bias to neutral in order to trim speculation about possible rate hike to defend the zloty.

Economic calendar

Time GMT	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (27 October)					
09:00	**PL**	**Auction of PLN1bn of 13-week and PLN1bn of 52-week Treasury bills**					
09:00	DE	Ifo index	Oct	pts	91.0	-	92.0
09:00	EZ	M3 money supply	Sep	%YoY	8.5	-	8.8
14:00	US	New home sales	Sep	m	0.46	-	0.46
		TUESDAY (28 October)					
07:00	DE	GfK index	Nov	pts	1.5	-	1.8
13:00	US	Case/Shiller house price index	Aug	%YoY	-16.6	-	-16.3
		WEDNESDAY (29 October)					
12:00	**PL**	**MPC decision**		**%**	**6.0**	**6.0**	**6.0**
12:30	US	Durable goods orders	Sep	%MoM	-1.3	-	-4.8
18:15	US	FOMC decision		%	1.00	1.00	1.50
		THURSDAY (30 October)					
10:00	EZ	Economic sentiment	Oct	pts	86.0	-	87.7
12:30	US	Advance GDP	Q3	%	-0.5	-	2.8
12:30	US	GDP deflator	Q3	%	3.6	-	1.3
12:30	US	Core PCE	Q3	%	2.3	-	2.2
12:30	US	Jobless claims	w/e	k	478.0	-	480.25
		FRIDAY (31 October)					
10:00	EZ	Flash HICP	Oct	%YoY	3.3	-	3.6
12:30	US	Core PCE	Sep	%MoM	0.1	-	0.2
13:45	US	Chicago PMI	Oct	pts	51.5	-	56.7
13:55	US	Final Michigan index	Oct	pts	57.5	-	70.3

Source: BZ WBK, Parkiet Reuters;

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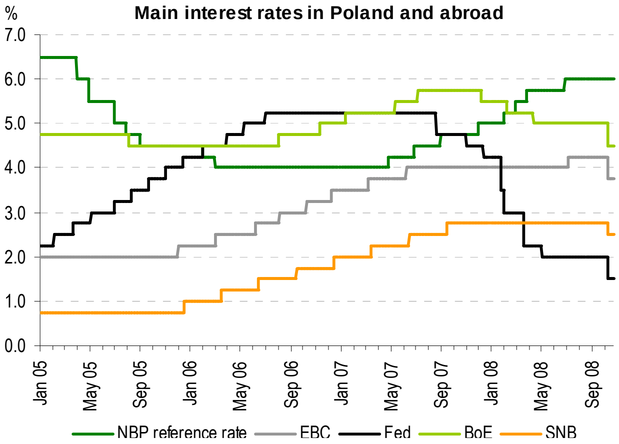
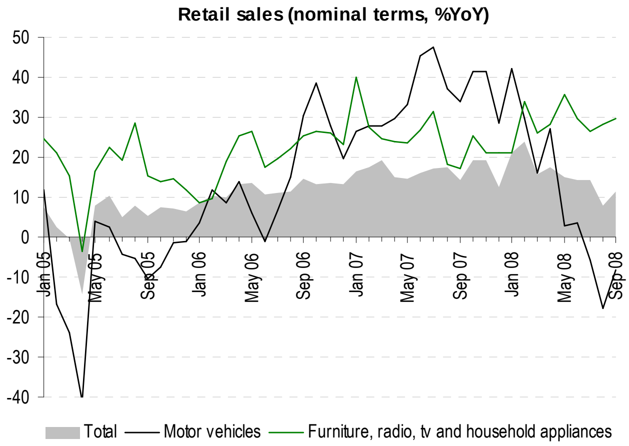
What's hot this week – Another turbulent week?



▪ This week there will be no important data releases, though they receded into the background anyway, given poor market sentiment and huge risk aversion globally. However, some events may be important in terms of perception of the Polish market. The Cabinet Council (government and President) will meet on Tuesday and the government is expected to accept the Poland's road map to the euro zone. Such a decision may limit the negative effect of global events on Polish assets. This would be especially the case if the agreement with the opposition is reached to change the Constitution.

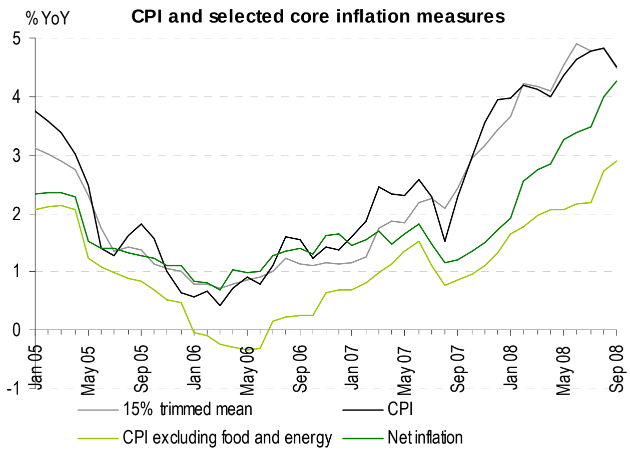
▪ On Wednesday the MPC (as well as Fed) will announce the decision on rates and at the end of the week the new *Inflation Report* will be published. In our opinion, market's speculation on possibility of rate hike to defend the zloty are unfounded. We expect rates on hold and we see chance to bias change to neutral.

Economy last week – September's data not so bad, but moods deteriorate



▪ Retail sales rose in September by 11.6%YoY (8.3% in real terms). If one excludes the car market (influenced by high private import, not covered by statistics) the sales figure is still in the strong upward trend of above 20-30%YoY in most of segments. This confirms strong domestic demand, though one should expect a deterioration in upcoming quarters due to less favourable situation on the labour market. Nevertheless, private consumption will remain the stabilizing factor in the terms of GDP growth next year.

▪ The unemployment rate fell in September significantly to 8.9% (against expectations at 9.3%). At a first glance such result is very optimistic, though one should take into consideration a clear fall in number of unemployed results from continuation of work on clearing of the registries, which was announced earlier by the government. At the same time the number of new registered unemployed rose significantly.



▪ CSO business climate indices showed a deterioration of entrepreneurs' sentiment in manufacturing and construction in October. Entrepreneurs expect quite substantial reduction in orders (especially form abroad), as well as lower activity and employment reduction. Business climate index for retail sector changed only moderately, confirming that domestic market performs much better and will remain the driver of GDP growth.

▪ Net inflation rose to 4.3% in September and CPI inflation excluding food and energy prices rose to 2.9%YoY. The remaining measures of core inflation fell, though were still above the 4% level.

▪ According to MPC minutes, there was a motion to hike rates in September, but there was no majority within the Council to support it, as majority of members were worried about growth prospects.

Quote of the week – Will market crash facilitate compromise on euro adoption and reforms?

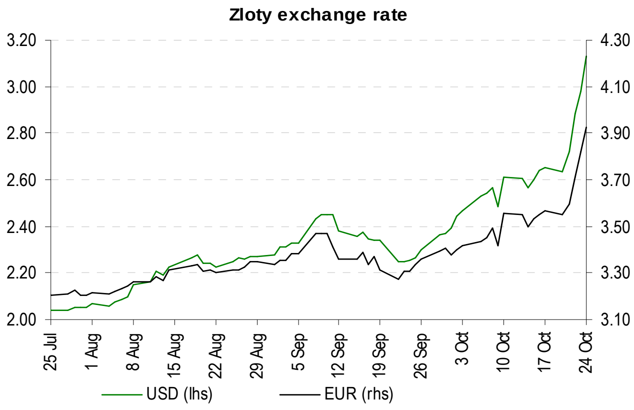
Lech Kaczyński, Poland's President, PAP, 24 October

The wide consensus is that one should do everything so that economic slowdown was relatively modest. The Polish economy has still sound fundamentals (…) and our banking system is strong. Deposits in banks are safe. Situation in insurance industry is also good, except for pensions funds which recorded large losses recently. (...) There are still arguments that Polish economy will grow, even though the growth rate may be somewhat lower.

I hope that in peace, without tensions and translating content-related disputes to political ground, we will be able to discuss the economic situation during the Cabinet Council.

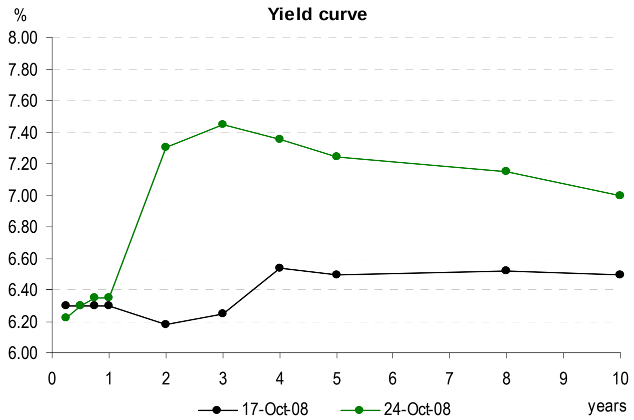
On Tuesday, meeting of the Cabinet Council will be held, during which not only an influence of the current crisis on the Polish economy, but also the euro zone entry issue will be discussed. A day earlier PM Donald Tusk will meet the opposition leader Jarosław Kaczyński on the latter issue. As to date, the Law and Justice leader has been strongly opposed to the idea of swift euro adoption. If this stance does not change, the government's aspiration may not be enough for the market to believe in the scenario of swift entry to the ERM2 and the euro zone. However, the current conditions are extraordinary and possibly – although it is difficult to say how likely it is – the PM will be able to convince the opposition to support the swift euro zone entry, maybe in exchange for concessions in other areas. If so, the zloty should gain and become less vulnerable to investors' aversion towards the emerging markets.

Market monitor



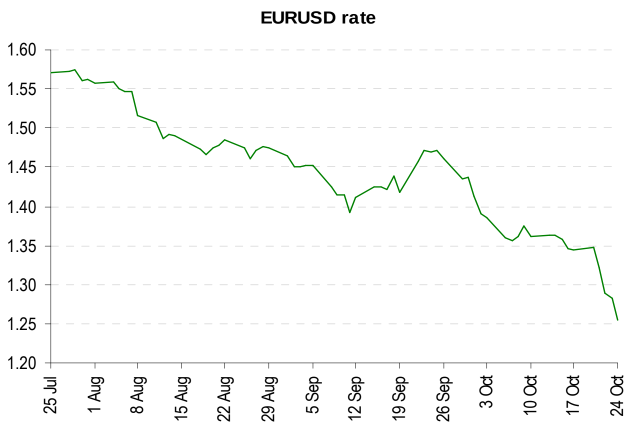
Record high zloty volatility

- The scale of zloty weakening in the past week on the wave of panic flee from emerging markets, exceeded all expectation, as well as deep falls from the past years. The EURPLN approached 4.00 rising in two days by ca. 45 gr (over 12%). The scale of the USDPLN fluctuations was even larger (change by almost 18%). At the end of the week the zloty FX rates recovered ca. half of the incurred losses.
- In the current market conditions the volatility is so high that forecasting a 10-gr trading band for the zloty on weekly basis is pointless. Certainly the 4.0 level will be an important barrier for the EURPLN though amid inflow of new negative news from abroad one may not rule out it will be broken (next strong resistance should be at 4.13).



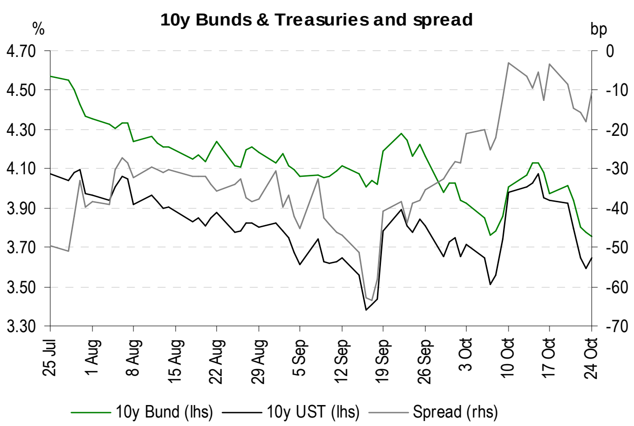
Significant jump in yields

- Strong risk aversion in the emerging markets resulted in a significant jump in yields, though it was done at marginal liquidity in the market. On the course of the week yield of some government bonds reached 8%. The FRA and IRS contracts followed the bond market on speculation, the MPC may head the Hungarian central bank and decide to raise interest rates in order to defend the zloty.
- In our view such thinking is unjustified and the MPC will leave rates unchanged. However, the substantial and permanent recovery in the debt market will be possible when moods toward the emerging markets improve. Similar as the zloty also bonds may be supported by strong declaration (best would be together with opposition) on fast euro adoption.



The dollar keeps appreciating

- The dollar was strengthening through most part of the week against the euro, among others after comments of Ben Bernanke and as a result of capital flow toward the safe haven assets. The expectations for an interest rate cuts by the ECB also added to euro weakening. After reaching ca. 1.25, the EURUSD rate slightly bounced back at the end of the week to 1,265, though during the whole week it fell by ca. 6%.
- A dramatic fall of stock indices in the US at the end of the week suggests the risk aversion and fears about consequences of recession will not disappear soon. A trend of retreat from risky assets and purchases of the dollar may result in further strengthening of the US currency, even if Fed cuts rates on Wednesday.



Safe assets gain as risk aversion rises

- The core debt markets significantly strengthened amid increased risk aversion and deep stock losses related to concerns about global recession. Over the last week yields of 10Y Treasuries and Bunds fell by 20bp and 35bp, respectively.
- This week moods in the stock markets will remain key driver for the core debt markets. The market's attention will be also focused on the FOMC meeting. In face of overall panic in the markets, the numerous data releases in the euro zone and the US are likely to remain in the background, however in general they should also support fall in yields.

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