



## POLAND WEEKLY REVIEW

### MACROECONOMICS AND FINANCIAL MARKETS

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- *Close pay position or open receive one if the global sentiment win with our fundamentals.*

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### PREVIEW: The week of August 17<sup>th</sup> to August 23<sup>rd</sup>

| Indicator         | Date of release | Period | BRE forecast | Con-sensus | Last  | Comment  |
|-------------------|-----------------|--------|--------------|------------|-------|--|
| Industrial output | Aug 20          | July   | 10.0%        | 11.1%      | 5.6%  | Two working days more compared to the analog period of 2006. Trend dynamics about 8% y/y.                                      |
| PPI y/y           | Aug 20          | July   | 1.5%         | 1.5%       | 1.8%  | Decline owing to high base effect.   |
| Retail sales      | Aug 22          | July   | 15.5%        | 17.4%      | 16.2% | In line with the underlying trend. The last figure has been distorted by an extraordinary rise in the sales of motor vehicles. |

## In Focus / Macroeconomics

*The Prime Minister announced that the Parliament will not agree for self-dissolving his cabinet will resign*

*The political instability may negatively influence Polish currency in the short term*

*The discrepancies between the forecasts and the actual figure resulted from lower food prices*

### The early election very likely

After the last speech of J.Kaczyński, the Prime Minister, the new election seems to be very likely. Kaczyński said that if the Parliament didn't dissolve, his cabinet would resign. The Parliament will vote the motion of self-dissolving in September. The exact date will be set by Sejm Speaker, who is a representative of PiS (Law and Justice). This motion has to be supported by 2/3 of deputies. Currently the members of Law and Justice, Civic Platform and Polish Peasants Party declared that they would vote for dissolving but together they have less than 2/3 of votes. The success of voting will depend of Democratic Left Alliance, who is undecided yet. We assess the probability of self-dissolving for 70%. Then, the election would occur on 18th of October. If the Parliament doesn't agree for self-dissolving J.Kaczyński will resign. Then we will have the three-step procedure: The President will propose a new Prime Minister, if he is not accepted by Sejm, then Sejm will propose a candidate. If his cabinet will not have the majority, the President will propose a candidate once again. If this possibility fails, then the President will have to announce the election.

We believe that in the current Parliament the majority coalition is impossible and Law and Justice wouldn't decide to form a minority government. That is why we assess the probability of earlier election for 90%. The current polls show that after the new election the coalition will be formed by Civic Platform and Left and Democratic (which is Democratic Left Alliance plus some small parties). This liberal coalition should be assessed positively by the market.

We think that during next several weeks some new political scenarios may appear, which will increase political instability. For that reason zloty may be negatively influenced by the political risk. In the longer term the behavior of Polish currency will depend on the election results. If Law and Justice wins the election (which can be not excluded) the party will have a problem in forming of a stable coalition. On the other hand if Civic Platform and Left Democratic Alliance will have a majority (the likelihood of this scenario is 70%) the market will react positively.

However we think that political risk is not a crucial factor for Polish currency. In our opinion, zloty will be influenced mostly by global situation and growing risk aversion, widening Polish current account and expected interest rates path. That is why we think that in Autumn EUR/PLN may touch 3.90.

### July inflation lower than expected not surprisingly for Polish MPC

Inflation rate dropped to 2.3% in July vs. 2.4% expected and 2.6% recorded in June. This decline can be explained partly by a high base effect (in summer 2006 internet fees went up). The discrepancies between the forecasts and the actual figure were the result, however, of lower food prices (1,6% m/m), which, according to our estimates are owing to extremely low prices of vegetables. A decline in food prices has been only partially neutralized by higher prices of tobacco that went up by 3.2% m/m as a result of higher excise tax. The prices in remaining categories, including those driven by consumer demand, shaped up in line with our estimates. For another month in a row, the major tendencies were confirmed. So, a gradual rise of inflation as measured on the basket of services and a decline in prices of tradables (prices of footwear and clothes dropped by 1.1% m/m) was recorded. This notwithstanding, the net core inflation due to the aforementioned high base effect dropped to 1.5% y/y. We estimate that inflation may further decline to about 2.0% in August. The final figure will be, however, strongly influenced by food prices. As for today, the prices of vegetables decline whereas the fruit prices go sharply up.

As the temporary decline in headline as well as in net core inflation has been fully anticipated by Polish MPC the impact of the actual figure on the ongoing interest rate decision may be very limited. In the comments that followed the release several MPC members (Wasilewska-Trenkner, Czekaj, Filar) signaled that the Committee would pay much more attention to the data on wages. This data is very likely to point to a continued rising wage pressure, which in the opinion of the majority of the MPC, will result in higher price pressure in the future. This opinion has been only recently contradicted by Nieckarz, seen as extremely dovish. He claimed that the deterioration of the productivity and profitability will naturally limit the wage rise already in the next year. It has to be noted that the current economic situation in Poland is quite unusual in many respects. For the first time since the transformation the labor market seems to be more or less balanced and the bargaining power of workers is on the rise. We do not think that this tendency reverts rapidly. We further assess that information stickiness as well as other economic mechanisms claimed to result in labor market rigidity will cause the wages to rise at the very

*We continue to expect that the MPC will hike the rates by total 100 bps by mid 2008*

#### MEDIUM-TERM FORECATS

high pace well beyond 2008. This, given more modest productivity growth rates may ultimately lead to a rising price pressure.

We continue to expect that the MPC will hike the rates by total 100 bps by mid 2008. In our opinion, with 60% likelihood as opposed to 100% likelihood already priced in, the Committee will hike the rates in August. This hike would be still seen as a preemptive one. The subsequent hikes will come in response to rising inflation rates.

| Indicator                       | 2006 | 2007        | 2008        |
|---------------------------------|------|-------------|-------------|
| GDP y/y (%)                     | 6,1  | 6,2         | 5,7         |
| Inflation rate (%)              | 1,0  | 2,4         | 3,2         |
| Current account (% of GDP)      | -2,1 | <b>-4,0</b> | <b>-4,8</b> |
| Unemployment rate (end-of-year) | 14,9 | 10,7        | 9,9         |
| NBP repo rate (end-of-year)     | 4,00 | 5,00        | 5,50        |

Source: GUS, NBP, BRE Bank, **bold** change on last week

## Fixed Income

*Not a safe haven any longer*

The period of complete immunity of the polish market to the global situation has apparently come to an end. International investors started to sell polish bonds, pushing the yield curve up significantly. Since economic fundamentals hasn't changed (current data, i.e. CPI at 2.3% y/y and wages at 9.3% do not change the outlook for rates, especially that more than 100bp of hike is already priced in the curve), it's difficult to find any better explanation for the recent move than simply risk aversion or plain panic. Even political situation and high probability of early elections isn't really a very negative scenario. In such environment we suggest not taking any outright risk on polish curve, as on one hand yield levels seem to be attractive to receive, but on the other hand if the global sentiment sustains, we can easily see the curve drifting up another 10bp within few days, especially that liquidity of the market is low. Our positioning for a steeper curve still seems to have profit potential, we recommend sticking to that position.

#### **RECOMMENDATION:**

Stay positioned for steeper curve

#### AUCTIONS

|                   | next auc. | offer | avg yield last | last auction date |
|-------------------|-----------|-------|----------------|-------------------|
| 13 Week T-bills   | -         | -     | 4,208%         | 16-01-06          |
| 26 Week T-bills   | -         | -     | 3,943%         | 24-04-06          |
| 52 Week T-bills   | 20-08-07  | -     | 4,816%         | 06-08-07          |
| 2Y T-bond OK1209  | 05-09-07  | -     | 5,185%         | 01-08-07          |
| 5Y T-bond PS0412  | 19-09-07  | -     | 5,480%         | 20-06-07          |
| 10Y T-bond DS1017 | 10-10-07  | -     | 5,658%         | 11-07-07          |
| 20Y T-bond WS0922 | 12-09-07  | -     | 5,309%         | 14-03-07          |

## Money Market

*Downward pressure for carry*

*USA problem means*

Stable carry just above the main market rate and another week with surplus of the cash in the system. It means that people are building their reserves. Another under-bided open market operation (19,3 vs 20 billion pln) plus local banks searching dollars through the usdpln swaps give additional pressure for the cost of carry to fall soon. If, of course, the situation repeats itself next week. If the answer is positive, we should face a very cheap end of the reserve.

*global problem*

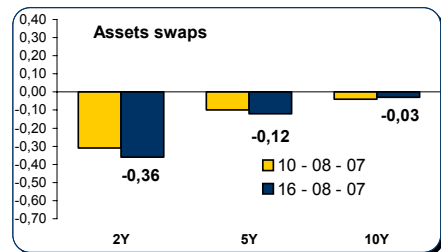
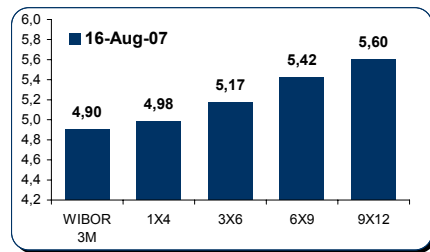
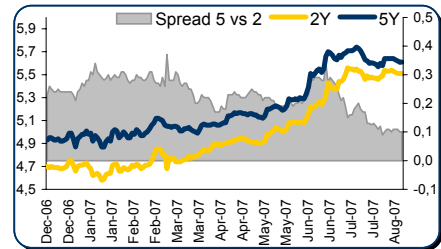
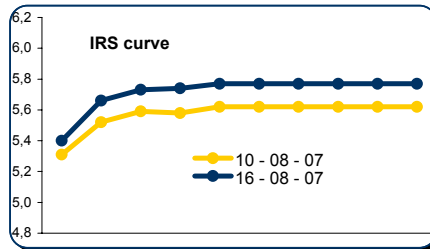
*Higher than expected half-year wages and monthly data can be crucial for the MPC*

As for longer terms bearish sentiment dominated the market. The biggest cause is of course sub-prime driven crisis in the USA, but also growing rates hike expectations for the August meeting. A half-year wages figure (8.9% vs 8.3% expected) was definitely a pro hike one. Slightly lower July CPI (2.3 vs 2.4%) did not change the situation much, and now crucial will be again wages. As of now the curve has built 100% chances for the August hike. T-bills auction did not bring any changes at all, as far as the yield is concerned. Average interest paid by the papers stayed at 4.82%.

**RECOMMENDATION:**

Close pay position or open receive one if the global sentiment win with our fundamentals.

**FIXED INCOME & MONEY MARKET CHARTS**



**Foreign Exchange**

*Zloty weaker*

This week zloty was traded between 3.7700 and 3.8430. Such sharp (2%) move is strictly correlated with high global risk aversion level and 5% loss on EURJPY value. As bad sentiment is wide spreaded we don't see possibilities to back below 3.8000 this week and 3.8050-3.8500 range is most likely.

*Volatility higher*

Implied volatilities for 1M jumped from 6.2 up to 6.9 and from 6 to 6.2 for 1Y. Until global sentiment won't get warmer market won't fall to 6 levels.

**RECOMMENDATION:**

RECOMMENDATION:

Spot:  
Main supports / resistances:  
EUR/PLN: 3.8050 / 3.8500  
USD/PLN: 2.7950 / 2.9000

*Zloty in side trend*

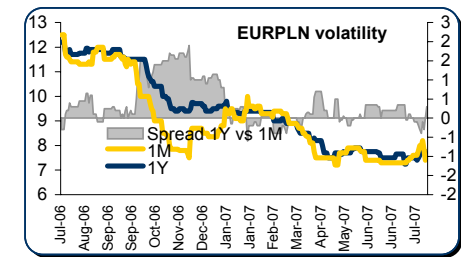
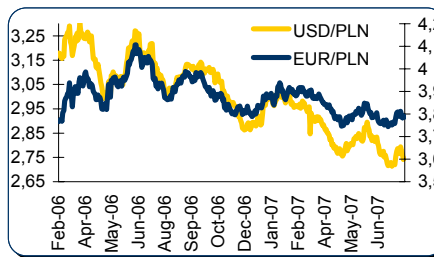
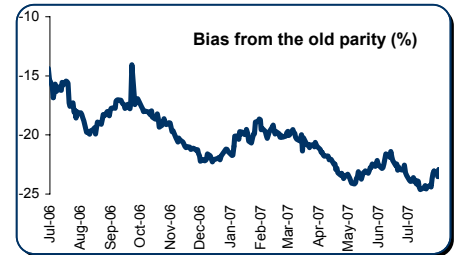
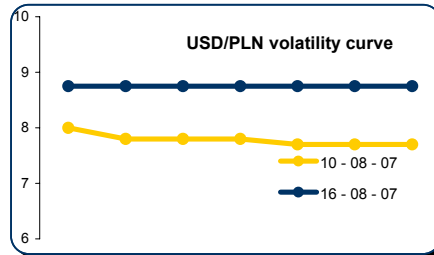
We see zloty in side trend, so we will be 3.8050 bidders and 3.8600 offerers.

Long gamma

FX CHARTS

Options:

Because of huge move on major markets volatility on PLN market will remain high so keeping long gamma may provide FX hedging opportunities



**MARKET PRICES UPDATE****MONEY MARKET RATES**

| Money market rates (Closing mid-market levels) |       |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|-------|
| date   | 3M    |       | 6M    |       | 1Y    |       |
|  | FXSW  | WIBOR | FXSW  | WIBOR | FXSW  | WIBOR |
| 10-08-07                                       | 4,85% | 4,89% | 5,01% | 5,06% | 5,32% | 5,35% |
| 13-08-07                                       | 4,96% | 4,89% | 5,09% | 5,10% | 5,39% | 5,37% |
| 14-08-07                                       | 4,96% | 4,90% | 5,09% | 5,10% | 5,39% | 5,37% |
| 15-08-07                                       | 4,96% | 4,90% | 5,09% | 5,10% | 5,39% | 5,37% |
| 16-08-07                                       | 4,96% | 4,90% | 5,09% | 5,10% | 5,39% | 5,37% |

**FRA MARKET RATES**

| FRA Market Rates (Closing mid-market levels) |       |       |       |       |       |
|--|-------|-------|-------|-------|-------|
| date   | 1X4   | 3X6   | 6X9   | 9X12  | 6X12  |
| 10-08-07                                     | 4,96% | 5,13% | 5,36% | 5,55% | 5,50% |
| 13-08-07                                     | 4,98% | 5,16% | 5,39% | 5,57% | 5,52% |
| 14-08-07                                     | 4,98% | 5,17% | 5,42% | 5,60% | 5,55% |
| 15-08-07                                     | 4,98% | 5,17% | 5,42% | 5,60% | 5,55% |
| 16-08-07                                     | 5,00% | 5,20% | 5,45% | 5,63% | 5,58% |

**FIXED INCOME MARKET RATES**

| Fixed Income Market Rates (Closing mid-market levels) |       |       |       |        |       |        |       |        |
|---|-------|-------|-------|--------|-------|--------|-------|--------|
| date  | 1Y    |       | 2Y    |        | 5Y    |        | 10Y   |        |
|   | WIBOR | TB    | IRS   | OK1208 | IRS   | PS0511 | IRS   | DS1017 |
| 10-08-07  | 5,35% | 4,87% | 5,55% | 5,24%  | 5,62% | 5,52%  | 5,62% | 5,58%  |
| 13-08-07  | 5,37% | 4,90% | 5,58% | 5,23%  | 5,62% | 5,53%  | 5,62% | 5,57%  |
| 14-08-07  | 5,37% | 4,90% | 5,62% | 5,26%  | 5,70% | 5,60%  | 5,70% | 5,68%  |
| 15-08-07  | 5,37% | 4,90% | 5,62% | 5,26%  | 5,70% | 5,60%  | 5,70% | 5,68%  |
| 16-08-07  | 5,37% | 4,95% | 5,66% | 5,30%  | 5,77% | 5,65%  | 5,77% | 5,74%  |

**PRIMARY MARKET RATES**

| Last Primary Market Rates |          |          |           |           |        |        |      |
|---------------------------|----------|----------|-----------|-----------|--------|--------|------|
|                           | au. date | maturity | avg price | avg yield | supply | demand | sold |
| 52W TB                    | 07-07-09 | 08-07-09 | 95,357    | 4,82%     | 500    | 1114   | 500  |
| OK0709                    | 07-08-01 | 09-07-25 | 90,485    | 5,19%     | 2000   | 2084   | 1399 |
| PS0412                    | 07-06-22 | 12-04-25 | 96,925    | 5,48%     | 1000   | 2673   | 1000 |
| DS1017                    | 07-07-11 | 17-10-25 | 96,817    | 5,66%     | 1800   | 2997   | 1800 |

**FX VOLATILITY**

| date     | USD/PLN 0-delta stradle |      |      |      | 25-delta RR |      | 25-delta FLY |      |
|----------|-------------------------|------|------|------|-------------|------|--------------|------|
|          | 1M                      | 3M   | 6M   | 1Y   | 1M          | 1Y   | 1M           | 1Y   |
| 10-08-07 | 7,80                    | 7,80 | 7,70 | 7,70 | 1,00        | 1,10 | 0,30         | 0,35 |
| 13-08-07 | 8,00                    | 8,00 | 7,90 | 7,90 | 1,00        | 1,10 | 0,30         | 0,35 |
| 14-08-07 | 8,00                    | 8,00 | 7,90 | 7,90 | 1,00        | 1,10 | 0,30         | 0,35 |
| 15-08-07 | 8,00                    | 8,00 | 7,90 | 7,90 | 1,00        | 1,10 | 0,30         | 0,35 |
| 16-08-07 | 9,25                    | 8,70 | 8,50 | 8,35 | 1,30        | 1,10 | 0,30         | 0,35 |

**PLN SPOT PERFORMANCE**

| PLN spot performance |         |         |         |
|----------------------|---------|---------|---------|
| date                 | USD/PLN | EUR/PLN | bias    |
| 10-08-07             | 2,7600  | 3,7775  | -23,74% |
| 13-08-07             | 2,7641  | 3,7755  | -23,71% |
| 14-08-07             | 2,7873  | 3,7842  | -23,35% |
| 15-08-07             | 2,7873  | 3,7842  | -23,35% |
| 16-08-07             | 2,8507  | 3,8277  | -22,11% |

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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