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FINANCIAL MARKETS DEPARTMENT

PAGES: 8 WARSAW, MAY 30, 2008

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of May 29th to June 5th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
FinMin's inflation forecast	**Jun 2**	May	**4.4%**	4.3%	4.0%	The reading distorted upwards by recent gas and electricity hikes. Also fuel prices exerted upward pressure on the figure whereas food prices resemble usual seasonality. We see net inflation reaching 3.3% y/y.
GDP y/y	**May 30**	Q1	**6.0%**	5.8%	6.1%	GDP dynamics close to the one recorded in the previous quarter. We see slightly softer growth of fixed capital investment and solid contribution of private consumption. The contribution of the former figure is likely to soften during the year whereas the effect of the latter may be relatively strengthened.

In Focus / Macroeconomics

Polish MPC to raise the rates in June

In line with market expectations, the MPC ceased fire this month. The next rate hike is very likely to come in June, so our and market expectations.

Turning to the details, the May MPC statement was very similar to the one issued in April. The Council stressed the possibility of spillover effects from higher energy and food prices. The very end of the statement, widely regarded as the part directly addressing the future actions of the Council, remained literally unchanged as compared to the last one. So, the risks for inflation are continuously seen on the upside. The Council acknowledged that bringing inflation back to the target may require additional tightening in the future. At the same time it agrees that perspectives for inflation will be much easier to assess based on the next month official inflation projection.

The Q&A session that followed the decision brought further statements highlighting the key role of June inflation projection. M. Noga, a hawkish MPC member, interviewed by press agencies regretted that the MPC had not hiked the rates already in May. He assured that he would certainly push for a rate hike in June to fight the rising inflation and wages. Turning to his inflation scenario, he expects now higher year-end inflation rate approaching 4.4% y/y and slightly elevated inflation projection to be released in June.

Based on our estimates (we make use of estimated equations from the official central bank model as well as impulse response functions documented in the central bank reports), inflation projection may lie above the previous one over the period of next 2-3 quarters, as the NBP staff may account for the immediate effects of higher energy and gas prices. The effects stemming from rate hikes and zloty appreciation may outweigh, the wage pressure , and so our conclusions based on the model, result in marked decline of inflation in 2009-2010.

Higher inflation figures to be released in June (our forecast 4.4% y/y) should boost or at least not allow rate hike expectations to subside. June rate hike may in turn be seen - at least temporarily - as a sign of the end of tightening cycle. Simultaneously, we maintain our view that inflation and high wage pressures will remain a worry in the mid-term. The new threat is here the rising oil price (a common threat for price stability in all emerging economies). That is why market participants will have to cope with elevated rates level for a longer period of time. Moreover, eventual rate cuts will be postponed far into the future.

Retail sales figures not really disappointing

According to the official data issued by the Central Statistical Office, retail sales accelerated in April to 17.6% y/y from 15.7% reported in March. Although market consensus was situated above the headline figure (at 18.8%), the divergence does not mark a significant change in the underlying trend as the reading was brought down by the slower pace of food prices (it may be partially attributed to the Easter effect as last year's shopping was spread between March and April whereas this year it was included fully in March). The hypothesis is backed by the dynamics calculated on food-and-fuels-excluding basis: it sustained momentum at 23.7% y/y, a way above last month's unexpected deceleration. As for the other categories, there were hardly surprising and returned to the average levels from previous months.

As far as prices are concerned, the retail sales deflator amounted to 3.6% y/y and was lower than the one recorded a month ago. The retail prices of "demand categories" (calculated from the headline figure excluding food and fuels) grew in April by 0.5% y/y – a touch above the last month's reading. We expect a quite sharp acceleration of inflationary processes this month – it is likely then the retail sales deflators will follow suit.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008
GDP y/y (%)	6,1	6,5	5,3
Inflation rate (%)	1,0	2,4	4,5
Current account (% of GDP)	-2,1	-4,5	-4,6
Unemployment rate (end-of-year)	14,9	11,4	9,8
NBP repo rate (end-of-year)	4,00	5,00	>6.0

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

Fixed Income

Nothing new

This week hasn't changed much on the market. Even though market corrected sharply from highest levels, the upside trend in yields has been resumed shortly afterwards. MPC's decision to leave rates unchanged was in line with market expectations and therefore had no impact either, especially that further comments suggested, that further tightening is likely to happen already in June. It's hard to expect the picture would change much in the nearest future. With no data release next week, market will concentrate on Ministry of Finance inflation projection, and that's likely to be higher. Still poor liquidity doesn't help long bond positions, weakening of the core market will put more pressure on the polish yield curve as well. Seems that the direction is still upwards.

RECOMMENDATION:

Stay pay. Add on dips.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6,061%	2008-04-14
26 Week T-bills	-	-	6,220%	2008-04-14
52 Week T-bills	2008-05-26	-	6,340%	2008-05-05
2Y T-bond OK0709	2008-07-02	-	6,193%	2008-04-02
5Y T-bond PS0413	2008-06-04	-	6,155%	2008-05-07
10Y T-bond DS1017	2008-07-09	-	6,054%	2008-04-09
20Y T-bond WS0922	2008-09-12	-	6,080%	2008-05-14

Money Market

Cheap end of the reserve is almost a fact now

Cheaper and cheaper as far as cost of carry is concerned, plus exponentially growing surplus in the reserve account. This makes the end of the reserve very cheap in almost 100%. Open market operation will not be able to change much taking care of the new period rather then trying to avoid inevitable.

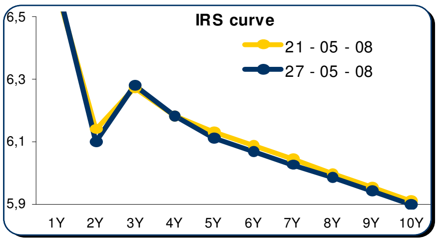
Hike in June fully priced in

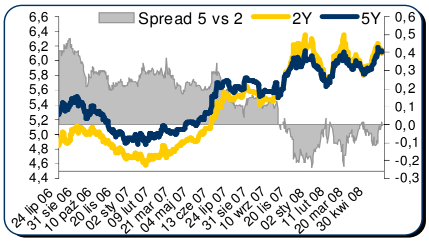
The MPC did not change any parameters of the monetary policy, which was fully expected by the market. Common expectations also for June which are 25 bps hike. It is totally priced in so no value in this bet. On Thursday longer terms went crazy bearish after not too optimistic comments made by Moody's and considering our broadly taken region. Truth is that the outlook for Poland was quite good; however EM basket was hurt in total.

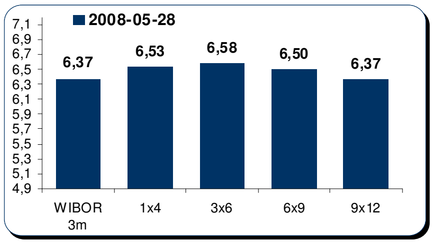
RECOMMENDATION:

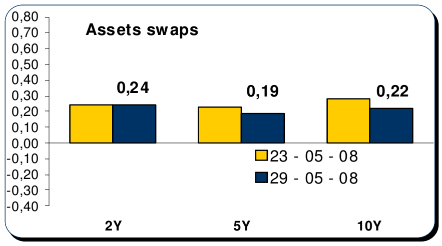
Stay neutral for a while since range trading is all we will see for the coming week.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Today (29th of May) we finally broke the support and the important barrier level at 3,300. After touching the low at 3.3720, EUR/PLN was brought back to 3.3880. In the short term, we expect the EURPLN to reach 3.3500 – lower target. There are plenty of barriers on the way, 3.3700 and 3.3600 being the biggest ones.

Volatility curve slightly lower

At the end of the last week the US investment name was the big buyer in longer term EUR/PLN volatility especially in 2 years (paid at as high as 6.05). It has elevated the whole EUR/PLN volatility run. Now being again sold with the stronger CEE4 performance.

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.3500 / 3.4000
USD/PLN: 2.1300 / 2.2200

Sell spikes

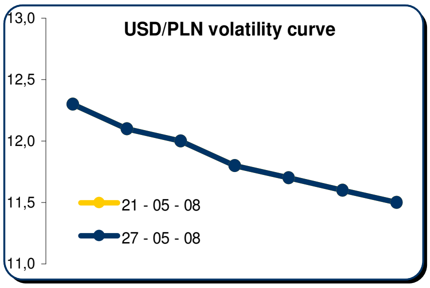
We are treating the 3.3800 as the pivotal level. Market close below that level, would confirm the move toward 3.3500.

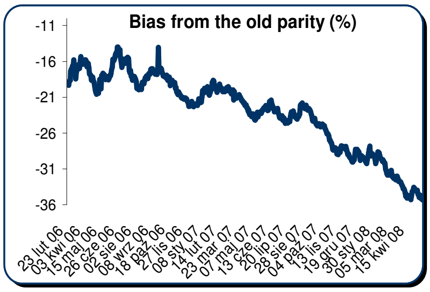
Options:

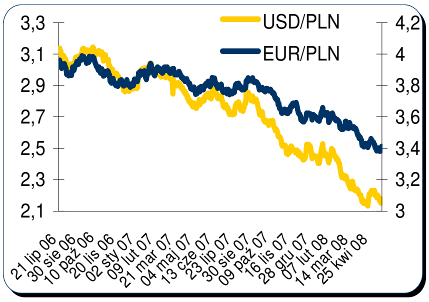
Stay aside/Short EURPLN gamma

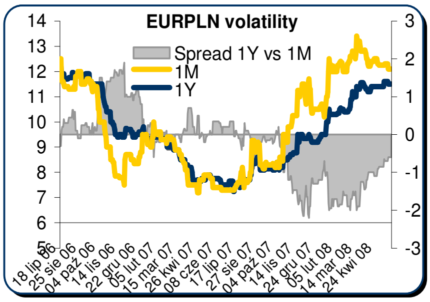
EUR/PLN volatility is being almost constant this year. We favour being slightly theta positive, waiting for the clearer signal to take same directional position.

FX CHARTS


USD/PLN volatility curve
13,0
12,5
12,0
11,5
11,0
21 - 05 - 08
27 - 05 - 08


Bias from the old parity (%)
-11
-16
-21
-26
-31
-36


USD/PLN
EUR/PLN
3,3
3,1
2,9
2,7
2,5
2,3
2,1
4,2
4
3,8
3,6
3,4
3,2
3


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
14
13
12
11
10
9
8
7
6
3
2
1
0
-1
-2
-3

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
22-05-08	6,36%	6,36%	6,50%	6,49%	6,65%	6,59%
23-05-08	6,36%	6,36%	6,50%	6,49%	6,65%	6,59%
26-05-08	6,37%	6,37%	6,46%	6,49%	6,58%	6,59%
27-05-08	6,35%	6,38%	6,49%	6,49%	6,59%	6,58%
28-05-08	6,33%	6,37%	6,30%	6,49%	6,58%	6,58%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
22-05-08	6,49%	6,53%	6,50%	6,38%	6,49%
23-05-08	6,50%	6,55%	6,49%	6,36%	6,47%
26-05-08	6,53%	6,55%	6,49%	6,36%	6,47%
27-05-08	6,51%	6,52%	6,44%	6,32%	6,43%
28-05-08	6,53%	6,58%	6,50%	6,37%	6,48%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK0709	IRS	PS0511	IRS	DS1017
22-05-08	6,59%	5,08%	5,57%	5,29%	5,72%	5,69%	5,73%	5,76%
23-05-08	6,59%	5,05%	5,57%	5,29%	5,71%	5,68%	5,72%	5,76%
26-05-08	6,59%	5,05%	5,57%	5,34%	5,71%	5,67%	5,71%	5,76%
27-05-08	6,58%	5,05%	5,56%	5,30%	5,71%	5,65%	5,72%	5,75%
28-05-08	6,58%	5,03%	5,56%	5,34%	5,70%	5,68%	5,70%	5,75%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	08-05-05	09-05-05	93,941	6,34%	2500	4123	2787
OK0710	08-01-02	09-07-25	85,730	6,19%	1800	2047	1654
PS0413	08-04-07	13-04-25	96,211	6,16%	1800	3129	1800
DS1017	08-02-13	17-10-25	96,048	5,79%	2000	2785	2000

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
22-05-08	12,10	11,80	11,70	11,50	0,70	0,85	0,30	0,35
23-05-08	12,10	11,80	11,70	11,50	0,70	0,85	0,30	0,35
26-05-08	12,10	11,80	11,70	11,50	0,70	0,85	0,30	0,35
27-05-08	12,10	11,80	11,70	11,50	0,70	0,85	0,30	0,35
28-05-08	12,10	11,80	11,70	11,50	0,70	0,85	0,30	0,35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
22-05-08	2,1675	3,4095	-34,86%
23-05-08	2,1623	3,4044	-34,98%
26-05-08	2,1578	3,4015	-35,07%
27-05-08	2,1610	3,3973	-35,08%
28-05-08	2,1728	3,3823	-35,12%

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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