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FINANCIAL MARKETS DEPARTMENT

PAGES: 9 | WARSAW, JULY 10, 2008

# POLAND WEEKLY REVIEW

## MACROECONOMICS AND FINANCIAL MARKETS



**PREVIEW: The week of July 11th to July 17th**

| Indicator | Date of release | Period | BRE fore-cast | Consen-sus | Last | Comment |
|---|---|---|---|---|---|---|
| **M3 Supply y/y** | **Jul 14** | Jun | **15.6%** | 15.6% | 15.0% | Substantial y/y dynamics stems partially form statistical effects (low base from June 2007 and substantial jump recorded in January 2008). Solid growth of household deposits fuelled by further withdrawals from investment funds. |
| **CPI Inflation y/y** | **Jul 15** | Jun | **4.5%** | 4.5% | 4.4% | Seasonal drop of food prices (ca 1% m/m) uncertain (symmetric risk); inflation on fuels 4% m/m. We expect the new measure of core inflation to top 2.1-2.2%. Feedback effects from higher energy prices still contained and close to our earlier assessment. |
| **C/A balance** | **Jul 15** | May | **-1.4 bn EUR** | -1.69 bn EUR | -1.5 bn EUR | Softer business activity in May. Import and exports dynamics close to 20% y/y. Substantially negative income account (dividend expatriation) contributes to higher C/A deficit – we expect it to have reached 4.1% of GDP in May. |
| **Wages y/y** | **Jul 15** | Jun | **11.7%** | 11.2% | 10.5% | Still in trend. Latest reading depressed by lower business activity in May (long weekends, lower number of extra-hours worked). Bonuses paid in KGHM. |
| **Employment y/y** | **Jul 15** | Jun | **5.1%** | 5.2% | 5.3% | Weak business indicators concerning employment (an outright decline expected in manufacturing). High wages |

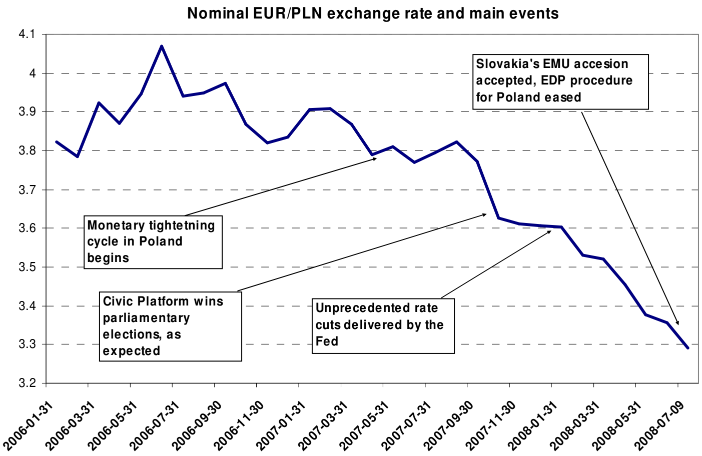
| | | | | | | |
|---|---|---|---|---|---|---|
| | | | | | | and material costs discourage expansion of employment in the light lower inflow of new orders. |

# In Focus / Macroeconomics

## Strong zloty = no hikes?

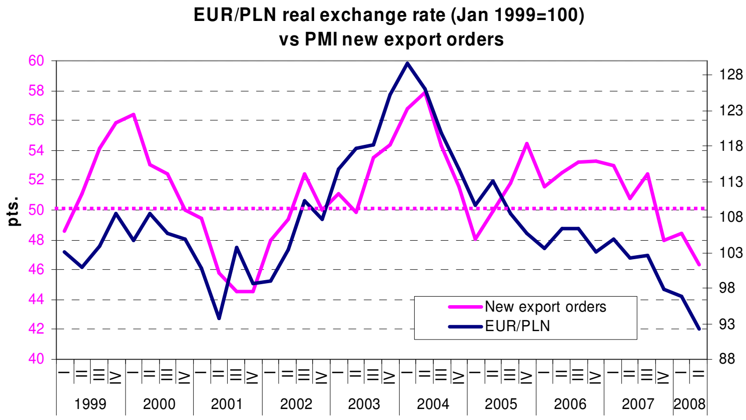
Just after the ECB statement Polish zloty has experienced accelerated appreciation which has brought EUR/PLN below 3.30 – a psychological frontier – and it is heading now towards the next support at 3.25. At the same time, the comments of MPC members have become more dovish as if they had been trying to talk the zloty down. Rate expectations are going downwards as the stronger currency helps to achieve price stability and hampers export possibilities. It is the future data though, which will be decisive on rates. We maintain a possibility of a hike in August/September.

Since the start of the year, Polish zloty has strengthened by no less than 9% (much above the typical pace resulting from real convergence premium which accounts roughly for 5-6% average appreciation during a calendar year). The boost from the last year seems to have been intensified lately. Some of the confidence-credit granted for the ruling coalition just after the autumn elections was given further support as Poland was excluded form the Excessive Deficit Procedure meaning it has reduced the budget deficit in a sustainable way. On the other hand, the outflow of funds from turbulent markets of world financial leaders was somehow backed by the assertion that growth perspectives in emerging markets are better than those in the U.S. and euro zone. Some of the mentioned events are pictured in the chart below.




Many rate-setters voiced their concerns on the current levels of the EUR/PLN exchange rate. In their opinions part of the rise results of course from the solid footings of the Polish economy, part may be rather stemming from speculation, though. Putting aside the discussion of causes and effects, appreciating zloty constitutes a natural channel which backs monetary policy but at the same time it may be an obstacle for GDP growth as it reduces exports. Such a mechanism has recently limited expectations on future rates, backed by relatively dovish comments of the rate-setters: M. Pietrewicz opted for waiting for October projection, D. Filar softened his earlier remarks on the necessity to raise rates also in 2009, H. Wasilewska-Trenkner has left the decision for the coming data. We fully comply with her scenario, conditioning our forecast on the inflow of macroeconomic figures.

As for the impact of exchange rate on inflation, we covered this topic quite thoroughly in some previous issues of this publication. We shall stick then to the links between the strong zloty and GDP growth. The picture below shows the relationship between real EUR/PLN exchange rate and the volume of the new export orders, as measured by the corresponding component of the PMI index. It is quite clear that falling exchange rate (i.e. stronger zloty) contributes to the lower inflow of the new orders. After an exceptional performance of such orders after joining the EU (the creation of trade effect), we detect clearly visible slide below 50 pts. mark in recent months, which may continue further amid weakening global demand.




The new orders index is one of the best leading indicators of industrial output (supply side). No more than a month ago, manufacturing firms declared they are willing to *lay off* some workers. We see then a considerable risk to the real sphere of the economy in the coming months. The first victim of slower demand will be the manufacturing (working to a large extent on foreign orders and hit hard by strong exchange rate); retail sales is unlikely to loose steam so fast as it is fuelled by strong wages. We think the MPC may have so far underestimated the balance of risks to growth and will fully learn it from the coming data (July-August).

As for inflation, the MPC will seek to disentangle the second round effects of rising fuels and energy. We estimate them to be still limited in comparison with the strong intensity of the cost shock. We advise then to closely watch the composition of the coming CPI figures – given the strong currency appreciation the feedback effects may shrink as well, leaving thereby less room for monetary tightening. There is still a perception shock connected with a summer hump of inflation path – the MPC may decide then to communicate their willingness to maintain price stability by hiking in August or September. Given the problems emerging for the real sphere and current EUR/PLN exchange-rate level (it may loose some steam when problems concerning the growth rate will become more pronounced), we would rather advise to look at the mentioned hike in terms of risk, but not a negligible one.

***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

*Expected "unexpected" rally*

Last week we saw quite a big rally on the whole curve. The best performing sector was 5y and especially bonds PS0412 and PS0413 which made more than 120 cents. Rally on 2y was also impressive and fast from Fridays 7.02% high to 6.65% low 4 day after. We saw big interest from investment bank books as well as OFE (open pension funds) running after yield. The 10y sector slightly underperformed. While we see still big room for yields to come down and we see big value in bonds we will take opportunity to close our positions on such a volatile move. Next week we will have economic releases and we still see pressure from TFI (local funds) as they are forced to liquidate assets, so it is not excluded that another wave of weakness may hit bond market. We think still market is in range and at current levels (2y at 6.65 and 0413 at 97.75) are close to bottom. Since we are rather bullish on the market, our strategy right now is to buy bonds on dips, although at current levels we are neutral.

***RECOMMENDATION:***

Reduce long position in bonds after recent rally.

***AUCTIONS***

| | next auc. | offer | avg yield last | last auction date |
|---|---|---|---|---|
| 13 Week T-bills | - | - | 6.061% | 4/14/2008 |
| 26 Week T-bills | - | - | 6.220% | 4/14/2008 |
| 52 Week T-bills | 7/14/2008 | - | 6.850% | 7/7/2008 |
| 2Y T-bond OK0709 | 8/10/2008 | - | 6.500% | 7/9/2008 |
| 5Y T-bond PS0413 | 9/3/2008 | - | 6.155% | 5/7/2008 |
| 10Y T-bond DS1017 | 7/9/2008 | - | 6.054% | 4/9/2008 |
| 20Y T-bond WS0922 | 9/12/2008 | - | 6.080% | 5/14/2008 |

## Money Market

*Another cheap week behind*

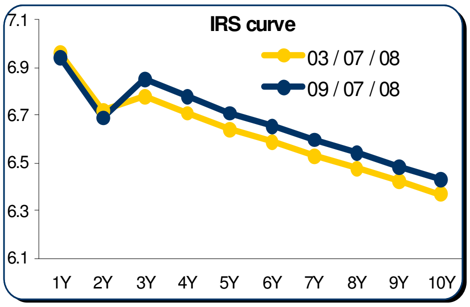
*Bond rally and strong pln triggered bullish for the rest IR instruments*

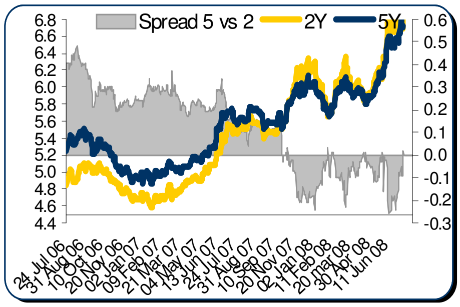
Another very cheap week behind as far as cost of carry is concerned. Open market operation was quite balanced, however players bought only 12 out of 16 billion pln worth of money bills offered. Tomorrow probably all the bills will be absorbed and we can expect quite a substantial offer, because another cheap week would mean cheaper and cheaper for the rest of the month. As for longer terms buyout of the bonds plus historically strong pln pushed all the yields significantly down. However, in the terms of fundamental analysis nothing has changed. Growing and in our opinion persisting CPI will force the MPC to further hike the rates and latest ECB comments suggest that polish council may not be isolated in the movement.

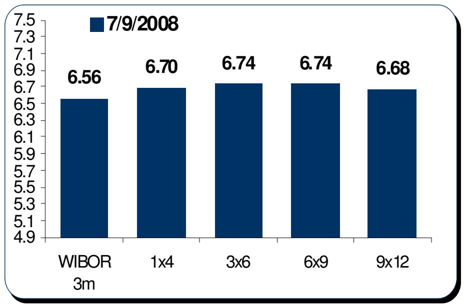
***RECOMMENDATION:***

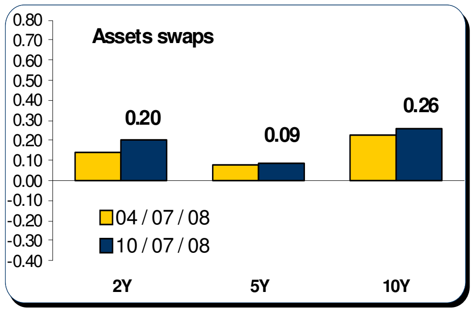
Pay 3,6M OISs.

***FIXED INCOME & MONEY MARKET CHARTS***




## Foreign Exchange

*Zloty stronger*

This week PLN started with 3.3150 top and headed to 3.2630 as new all times low. Reasons of strengthening were pricing in expectations for further rate hikes and setting EURSKK conversion rate.

*Volatility curve higher*

Breaking of decent amounts of option barriers, placed below 3.35, finally worked with visible demand for EURPLN gamma and vega. Volatility curve started to be well bided with trades on 1M at 6.4 and 1Y 6.25.

***RECOMMENDATION:***

Spot:
Main supports / resistances:
EUR/PLN: 3.2500 / 3.3300
USD/PLN: 2.0600 / 2.1300

*Look for buying levels*

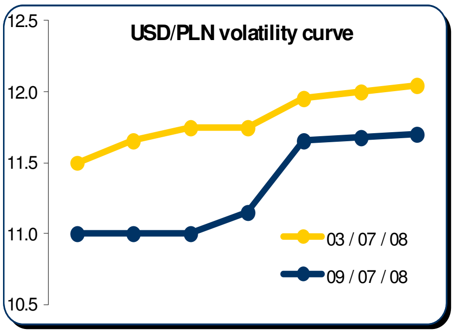
Though PLN trend is indisputable, we see PLN a little bit overbought with rising likelihood of correction toward 3.3300.

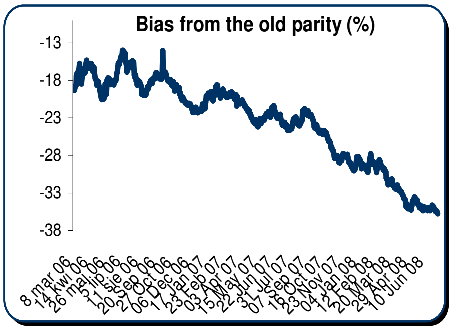
Options:

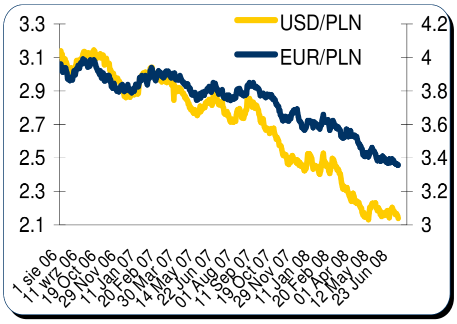
*Sell vega on upticks*

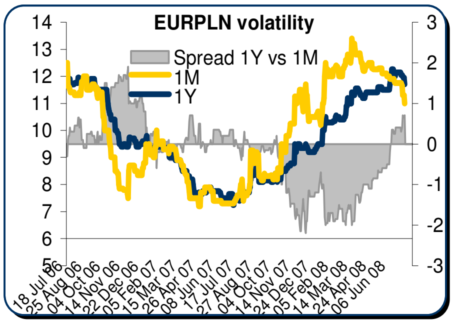
We believe present demand for PLN gamma/vega is temporary and suggest selling vega it on upticks. On the other hand if PLN correction in any figure would took place we recommend selling gamma for theta gains.

## *FX CHARTS*


USD/PLN volatility curve
12.5
12.0
11.5
11.0
10.5
03 / 07 / 08
09 / 07 / 08


Bias from the old parity (%)
-13
-18
-23
-28
-33
-38


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
5
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 |
| 03/07/08 | 6.60% | 6.57% | 6.78% | 6.73% | 6.88% | 6.81% |
| 04/07/08 | 6.53% | 6.56% | 6.62% | 6.72% | 6.90% | 6.82% |
| 07/07/08 | 6.54% | 6.56% | 6.71% | 6.72% | 6.81% | 6.81% |
| 08/07/08 | 6.53% | 6.56% | 6.45% | 6.71% | 6.67% | 6.81% |
| 09/07/08 | 6.52% | 6.55% | 6.66% | 6.68% | 6.79% | 6.80% |

### FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

| date | 1X4 | 3X6 | 6X9 | 9X12 | 6X12 |
|---|---|---|---|---|---|
| 03/07/08 | 6.82% | 6.87% | 6.88% | 6.88% | 6.93% |
| 04/07/08 | 6.78% | 6.88% | 6.89% | 6.88% | 6.94% |
| 07/07/08 | 6.77% | 6.82% | 6.83% | 6.80% | 6.87% |
| 08/07/08 | 6.71% | 6.71% | 6.71% | 6.68% | 6.78% |
| 09/07/08 | 6.70% | 6.74% | 6.74% | 6.68% | 6.77% |

### 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 |
| 03/07/08 | 6.81% | 5.08% | 5.57% | 5.29% | 5.72% | 5.69% | 5.73% | 5.76% |
| 04/07/08 | 6.82% | 5.05% | 5.57% | 5.29% | 5.71% | 5.68% | 5.72% | 5.76% |
| 07/07/08 | 6.81% | 5.05% | 5.57% | 5.34% | 5.71% | 5.67% | 5.71% | 5.76% |
| 08/07/08 | 6.81% | 5.05% | 5.56% | 5.30% | 5.71% | 5.65% | 5.72% | 5.75% |
| 09/07/08 | 6.80% | 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 | 08/06/16 | 09/06/16 | 93.601 | 6.76% | 1400 | 4385 | 1443 |
| OK0710 | 08/04/02 | 10/07/25 | 87.000 | 6.19% | 2700 | 4925 | 2700 |
| PS0413 | 08/04/07 | 13/04/25 | 96.211 | 6.16% | 1800 | 3129 | 1800 |
| DS1017 | 08/07/09 | 17/10/25 | 91.480 | 6.50% | 700 | 2461 | 705 |

### FX VOLATILITY

| | USD/PLN 0-delta stradle | | | | 25-delta RR | | 25-delta FLY | |
|---|---|---|---|---|---|---|---|---|
| date | 1M | 3M | 6M | 1Y | 1M | 1Y | 1M | 1Y |
| 03/07/08 | 11.65 | 11.75 | 11.95 | 12.05 | 0.70 | 0.85 | 0.30 | 0.35 |
| 04/07/08 | 11.30 | 11.50 | 11.95 | 12.00 | 0.70 | 0.85 | 0.30 | 0.35 |
| 07/07/08 | 11.30 | 11.50 | 11.85 | 11.95 | 0.70 | 0.85 | 0.30 | 0.35 |
| 08/07/08 | 11.30 | 11.50 | 11.85 | 11.95 | 0.70 | 0.85 | 0.30 | 0.35 |
| 09/07/08 | 11.00 | 11.15 | 11.65 | 11.70 | 0.70 | 0.85 | 0.30 | 0.35 |

### PLN SPOT PERFORMANCE

PLN spot performance

| date | USD/PLN | EUR/PLN | bias |
|---|---|---|---|
| 03/07/08 | 2.1625 | 3.3662 | -35.43% |
| 04/07/08 | 2.1681 | 3.3657 | -35.37% |
| 07/07/08 | 2.1605 | 3.3635 | -35.48% |
| 08/07/08 | 2.1538 | 3.3585 | -35.62% |
| 09/07/08 | 2.1420 | 3.3585 | -35.75% |

*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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