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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, AUGUST 14, 2008

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of August 15th to August 21th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Wages in enterprise sector y/y	Aug 18	Jul	**10.9%**	11.4%	12.0%	Consistent with the underlying trend. Last reading distorted by bonus payments in mining.
Employment in enterprise sector y/y	Aug 18	Jul	**4.5%**	4.6%	4.8%	Employment is slowly receding and moving closer to falls on monthly basis. Expected employment in business tendency indicators trending downwards.
Industrial Output y/y	Aug 20	Jul	**5.8%**	7.3%	7.2%	One day more on annual basis. New order books filling at negative pace, confirmed by contracting business tendency indicators.
PPI y/y	Aug 20	Jul	**2.3%**	2.5%	2.7%	Monthly drop of oil prices and all base metals. Record high appreciation of the zloty (4.6% m/m to the dollar and 3.6% to the euro).
Core 'Net' Inflition y/y	Aug 21	Jul	**3.5%**	3.5%	3.4%	Feedback effects still limited. We expect the core inflation excluding food and energy at previous month's level of 2.2% y/y.

In Focus / Macroeconomics

Feedback effects still very limited, oil price and cyclical slowdown to weigh on inflation and Polish rates outlook

July inflation came out without major surprises edging up to 4.8% y/y from 4.6% recorded in June. As for the breakdown, July saw only moderate seasonal drop of food prices (-1.1% m/m) and relatively minor jump of tobacco prices (the major impact of higher excise tax is to be transmitted into CPI in August). Among non-food categories, highest growth rates were for the next consecutive month recorded in recreation and culture (0.8% due to dearer package holidays), restaurants and hotels (0.6%, a derivative of more costly food and energy prices) and transport (0.5%, owing much to higher prices of fuels). We estimate the core "net" inflation to have reached 3.5% y/y (in line with our previous calculations) and the core inflation excluding food and energy to stay at 2.2% y/y, the level recorded in June. Thus, much feared feedback effects continuously prove to be only moderate.

The view on Polish inflation and rates seems to be currently shaped predominantly by two external factors. These include prospects of slower growth in the whole Europe and lower oil prices, both likely to drag headline inflation down (and moderate the risk of elevated inflation expectations as well) across all emerging economies. As for the local factors, it is the inflation peak projected for August (inflation should then peak due to base effect) and the zloty exchange rate that are to affect rate expectations. Much has changed in recent days with relation to the former factor though. Food and oil prices may hold inflation below 5% in August, limiting the height of inflation peak, contrary to catastrophic prophecies of recent months (calculated under neutral oil price scenario). On the other hand, the inflationary impact of the zloty depreciation is probably still insufficiently pronounced phenomenon to be debated on.

In our opinion, limited feedback effects are going to translate into more favorable mid-term inflation perspectives, in particular. All the above cited factors, including especially the cyclical slowdown are likely to limit the scope for any corrective upward moves on official rates. Another important issue to dominate the rates outlook is the shape of inflation path in autumn. We expect the headline inflation to trend downwards then on the back of arithmetical high base effects from 2007 (last year almost 15% rise in fuel prices and a 6% rise in food prices were reported in this period). Such a sequence of events may bring the end of tightening cycle sooner that has been previously anticipated.

C/A deficit at historical lows. Slowing exports to negatively affect GDP growth.

C/A deficit widened sharply in June reaching 2 292 mln EUR, beating market expectations situated at 1 600 mln EUR. It is the highest reading since year 2000, when the data started to conform to the IMF methodology. Apart from the current transfers balance which recorded an unexpected jump to 664 mln EUR, all other components of the breakdown worsened.

The trade deficit expanded to 1 706 mln EUR owing to elevated growth rate of imports (20.2% y/y vs. expected 17.5%) and slower exports (16.1% y/y vs. expected 17.0%). The latter figure recorded a meager growth rate when calculated in PLN – only 2.9% y/y – confirming earlier signals flowing from business tendency indicators. According to our calculations, the contribution of exports to GDP growth may fall in Q2 to -0.9 pp. (from -0.3 recorded in Q1) and it is visibly trending downwards. The consumer demand slowly begins to spill over abroad owing to fading growth of domestic production, falling short of the expansion of disposable incomes.

As for the other elements of the balance of payments, substantial deficit was also recorded by the income balance, fuelled once again by dividend expatriation. We expect this factor to play an important role also in coming months. We observed a considerable drop of the balance of services (reaching only 4 mln EUR, the lowest level since the mid 2006) owing much to the fall of surplus recorded so far in transportation services.

The data on C/A deficit was largely ignored by the FX market as it refers to the historical data. Rate hike expectations are likely to be decisive for the EUR/PLN exchange rate in coming months thereby the domestic currency depreciation may come along with softer real sphere data.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.3	4.0
Inflation rate (%)	1.0	2.4	4.5	3.7
Current account (% of GDP)	-2.1	-4.5	-4.6	-5.3
Unemployment rate (end-of-year)	14.9	11.4	9.8	9.6
NBP repo rate (end-of-year)	4.00	5.00	6,0-6,25	5.75

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.3	4,8?	4.3	3.8	3.8
Inflation rate (%)	4.3	5.0	4.4	3.9	3.7
NBP repo rate (end-of-quarter)	6.00	6,0-6,25	6,0-6,25	6,0-6,25	6,0-6,25

Bold denotes chages from the last release with arrows showing the direction of chages

Fixed Income

Is it a kind of magic?

Last week we saw quite a significant rally on the bonds, as well as on the short curve. We saw good receiving interest especially in the 2y and 5y bonds, auctions were well supported. We think that the market is now trading in the bullish trend. The focus right now is growth as well as impact of the lower commodity prices on the future inflation outlook. Our economist is revising both CPI and GDP forecasts down, which makes us confident we will see lower yields across the curve. We see big probability of the CPI hump not happening, more over we see IP slowing down fast. We expect Wibor to gradually trend lower as the probability of hikes will be diminishing, and with that the most value lies in front end of the curve, as FRA will look very attractive to sell with WIBOR marching down. The fact worth underlying is that WIBOR can easily trade around 6.30-6.35 if market abandons hopes for rate hike this year. We also like 5y bonds which trade in yield above repo rate for the same reasons. We recommend adding receive positions on any market pullbacks. And for those who fear zloty will weaken and that will make investors resilient to buy polish bonds … zloty probably will weaken, but it is not magic it is just cyclical slow down which will be accompanied by lower yields. One cannot happen without the other.

RECOMMENDATION: buy 0413, sell 9x12 FRA

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	8/18/2008	-	6.627%	8/11/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
5Y T-bond PS0413	9/3/2008	-	6.155%	5/7/2008
10Y T-bond DS1017	10/8/2008	-	6.054%	4/9/2008
20Y T-bond WS0922	9/12/2008	-	6.080%	5/14/2008

Money Market

Stable cost of carry

Market is square as far as liquidity is concerned and it seems it will stay this way for coming days. It is also too early to forecast levels for the end of the reserve requirements settlement period.

Very strong market sentiment

Bullish regardless of high CPI, which was in line with expectations (4.8%) and loosing currency. Market does not believe in any further tightening of monetary policy, ignoring any hawks signaling more hikes this year. No point in playing against since the market sentiment is very strong and probability of next hike in September/October is nearly 50:50. It is worth waiting for a while

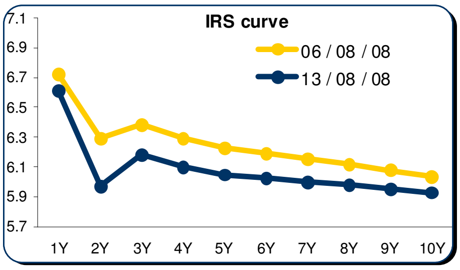
T-bills yields down during the tender

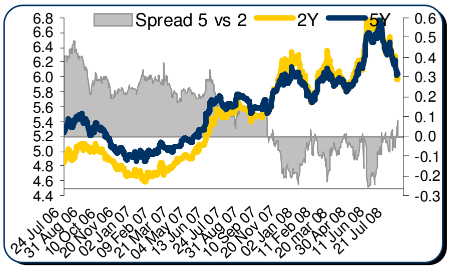
just to avoid adverse mark to market in short term. Lots of figures next week. Higher wages and core CPI will probably not generate as strong signal as lower IO these days. T-bills yields slightly down with benchmark average yield at 6.63%.

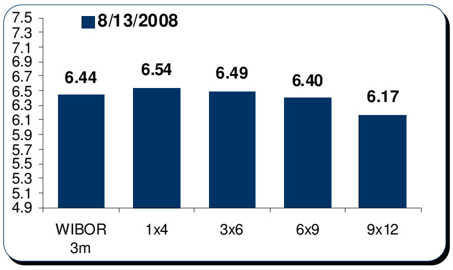
Pay 1Y polonia below 6.2%.

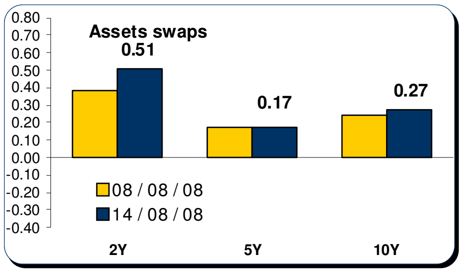
RECOMMENDATION:

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This week zloty has weakened considerably crossing on its path our stop-loss levels. EUR/PLN has rallied by almost 9 figures from 3.2365 to 3.3215, being followed by the USD/PLN move from 2.0878 last Thursday to 2.2292. Despite realized scenario we hold on to previous forecasts and extend stop levels to 3.3600 and 2.2550 respectively.

Volatility curve slightly higher

EUR/PLN volatility curve has not really changed, despite the heavy trading (1m 7.2% mid and 1y 6.5% mid). There is really healthy demand from US Investment names, and the supply comes from the polish customers. To the contrary USD/PLN is left to big volatility curve swings with hardly any trade being done. USD/PLN 1M increased by 1.75 to 13.25 (1Y by 0.40 to 12.50), mainly due to raised EUR/USD variance.

RECOMMENDATION:

SPOT
Main supports / resistances:
EUR/PLN: 3.2700 / 3.3600
USD/PLN: 2.1000 / 2.2450

Reduce long PLN positions

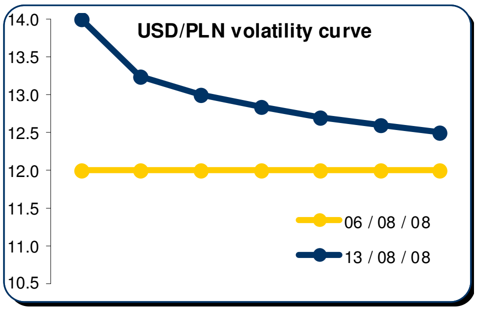
Recent market situation forced us to cut partially PLN exposition waiting for upcoming U-turn and the return to long-term .

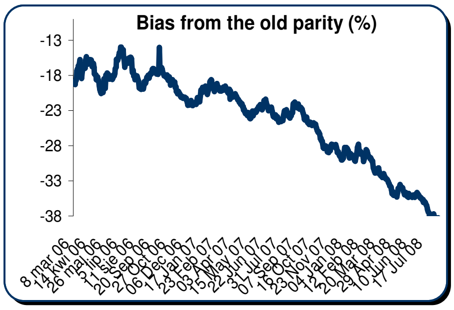
OPTIONS

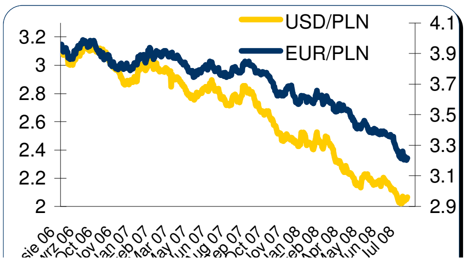
Hold short vega and gamma

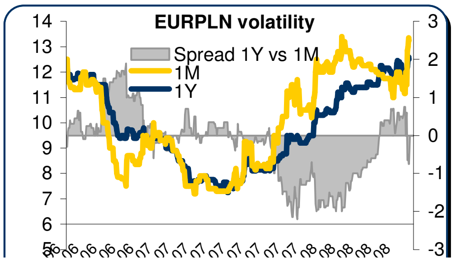
Keep short vega and gamma anticipating probable volatility curve mean reverting.

FX CHARTS









MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)						
date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
07/08/08	6.45%	6.36%	6.55%	6.49%	6.71%	6.59%
08/08/08	6.44%	6.44%	6.54%	6.53%	6.69%	6.68%
11/08/08	6.43%	6.45%	6.53%	6.53%	6.67%	6.68%
12/08/08	6.27%	6.44%	6.52%	6.52%	6.44%	6.67%
13/08/08	6.39%	6.44%	6.49%	6.53%	6.58%	6.66%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
07/08/08	6.55%	6.54%	6.50%	6.30%	6.46%
08/08/08	6.56%	6.59%	6.49%	6.29%	6.43%
11/08/08	6.57%	6.58%	6.48%	6.28%	6.42%
12/08/08	6.55%	6.56%	6.47%	6.26%	6.41%
13/08/08	6.54%	6.49%	6.40%	6.17%	6.35%

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
07/08/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
08/08/08	6.68%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
11/08/08	6.68%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
12/08/08	6.67%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
13/08/08	6.66%	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	08/08/11	09/08/11	93.720	6.63%	700	2414	700
OK0710	08/08/06	10/07/25	88.390	6.47%	1800	3724	1830
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
07/08/08	11.50	11.75	12.00	12.10	0.65	0.75	0.30	0.35
08/08/08	12.85	12.50	12.50	12.20	0.70	0.75	0.30	0.35
11/08/08	13.00	12.50	12.50	12.50	0.70	0.75	0.30	0.35
12/08/08	13.35	12.90	12.80	12.60	1.10	1.10	0.30	0.35
13/08/08	13.25	12.85	12.70	12.50	1.00	1.00	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
07/08/08	2.0420	3.2060	-38.70%
08/08/08	2.0400	3.2080	-38.70%
11/08/08	2.0494	3.2252	-38.39%
12/08/08	2.0539	3.2063	-38.56%
13/08/08	2.0509	3.2026	-38.64%

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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