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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, JULY 23, 2009

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of July 24th to July 30th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
MPC decision	Jul 29	-	**3.5%**	3.5%	3.5%	The MPC has no reason to interfere with rates right now as signals from the economy are mixed and need to be confirmed. Moreover, real interest rate is indeed at a low level. We see only a risk of a cut in Autumn.

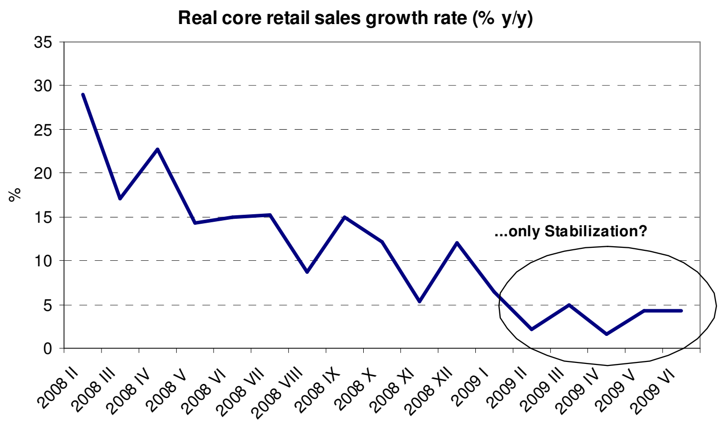
In Focus / Macroeconomics

Picture emerging from Q2 complete data set

After the release of (better as expected) retail sales data, the data set covering Q2 2009 may be seen as complete. Although the set of variables still lacks net exports data for June, we do not expect any surprises on this field – moreover, they would have to be really substantial to spoil the scenario we describe in this short piece. According to the fresh data, we see not only some signs of stabilization, but also a tentative turnaround (industrial output on which our GDP model is mainly based), which may be extended into coming quarters.

In every single month of Q2 industrial production readings proved to be better than expected. After falling by more than 10% in Q1, industrial output rebounded to almost -7% y/y in Q2. The advance is more straightforward in seasonally adjusted terms, though, from -11.5% in Q1 to -4.7% in Q2. Tendencies observed abroad (mainly German economy consuming 25% of Polish exports) give a chance for the domestic recovery to grow stronger in coming months. Such a scenario does not rely on output alone. We also see some signs of stabilization in employment (which we hardly connect with seasonal factors as employment indicators have been trending higher for some months now) which may imply that firm decided to hoard labor force in order to be ready to embark on first signs of rising business activity.

Although individual consumption may put reigns on the coming recovery, we are no longer such pessimistic on that field. First of all one should note that retail sales has somewhat stabilized (it is meaningful to look at "core retail" after fuels and food is excluded – this category better reflects the behavior of consumers over the business cycle – see the graph below). Secondly, consumer confidence (as reported by GUS) has recently began to rise which may pose some upside risks to the so far formulated forecasts. Another reasonable argument stems from labor market – although it is only speculation so far, it is a fact that this market is more flexible than in previous "recession" episodes. We think that flexibility reflects itself in reasonable low levels of lay-offs. It is possible that part of the impact of cost-cutting was absorbed by wage stagnation or wage cuts (also possible by narrowing the average working week) which may be regarded as less disruptive for consumer demand than redundancies themselves.



As the data set is almost complete, we may further elaborate on our Q2 GDP forecast (we signalle the revision in the previous report) . The model (which we also mentioned last week) shows a possibility of a 1% plus growth rate (1.2% exactly). As for the breakdown we are almost sure of fading consumption (2.5% y/y – although there is some downside risk on poor VAT collection) and investment (-4.0% y/y). Domestic demand is likely then to hit another floor (-1.8% y/y) damped additionally by destocking (-2.8pp. contribution). There is a bright spot, though. Just as in Q1, there is large net exports contribution of +3.0pp. which is likely to continue trough the whole 2009. To our (positive) surprise, our estimates have been officially corroborated by the Statistical Office – today's official communiqué points clearly that Q2 GDP growth will be close to Q1 (+0.8% y/y).

The data can carry the markets over on the wave of sustained optimism (Poland is outperforming Europe even more strongly) but there is also a serious risk to the budget problems hidden in the domestic demand – on the back of this, serious privatization plans are perfectly timed (see the piece below).

Poland to boost privatization revenues to PLN 36.7 bn in 2009-2010

The Treasury Ministry revised sharply its privatization plan and is going to raise PLN 36.7bn by the end of 2010. Among others, the Treasury is to sell its stake at Enea, Tauron, PGE, Energa, ZE PAK (electricity supplier), Ciech, Zakłady Chemiczne Police, Zakłady Azotowe Puławy, Zakłady Azotowe Tarnów, Zakłady Azotowe Kedzierzyn (chemical industry), Warsaw Stock Exchange, PKO SA, Bogdanka (mining), Ruch and Lotos (petroleum refining industry). It may also sell entire 41% stake in KGHM, the copper group with largest European crude output. In this way the Treasury expects to raise about PLN 10bn out of total 36.7 bn already in H2 2009.
Earlier the Treasury Ministry had estimated it would raise PLN 12 bn in 2010. The newest estimates are much closer to ours and, given the capitalization of state owned companies listed solely on the Warsaw Stock Exchange (about PLN 50bn out of which strategic stakes amount to PLN 25 bn), still quite realistic.

Accelerated privatization is thought to help limit borrowing and finance widening general government budget deficit. The latter is to top 7% in 2009 and about 6-7% in 2010. Thus, the government switches de facto to the risk management mode minimizing the risk of failing to issue bonds in the case global economy fails to recover in 2010. The effect of such a strategy should pretty quickly support Polish bond market as investors may warmly welcome any signs of limiting bond supply in the quarters to come The prospects of huge privatization flows from abroad will also positively impact the zloty exchange rates (we expects the zloty to breach 4.0 level against the euro rather sooner than later). The bottom line is, however, that once the economic prospects turn positive and risk aversion subsides, the government is very likely to relax the ambitious privatization plan.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	**1.1**	2.0
Inflation rate (%, average)	1.0	2.4	4.3	3.4	1.8
Current account (% of GDP, average)	-2.1	-4.5	-5.3	0.2	-2.9
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.8	13.5
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.50/25	3.75

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	0.8	**1.2**	**0.8**	**1.6**
Inflation rate (%, average)	4.7	3.8	3.2	3.7	3.4	3.5
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.50/25	3.50/25

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

Fixed Income

Waiting for the opportunity.

Last week was rather calm on the FI. Bonds spreads yet another week were tighter to swaps, WIBOR rates continued to go lower, cash stayed cheap. Economic releases didn't bring any change to the market, even if they were a bit away from expectations. From RPP member's comments we start to see that probability of further rate cuts is significantly limited. Looking back at our recommendations we were a little wrong with market behavior which is now driven by structural factors (liquidity, WIBOR premia, etc.) rather than macro/risk factor. We managed to close our pay position in front end with minor loss and for now we are taking sidelines as far as outright risk. As far as ASW positions we still see them a little bit overcrowded but right now there is no reason to be bearish ASW with ample liquidity and very positive perception of risk. But for us it has been quite a long run so we are happy to reduce our holdings here. Generally we are waiting for better opportunities to enter trades, with volatility being now so low we see little advantage in holding large risk positions at current levels as curve seems (unusually) to be rather fair priced.

RECOMMENDATION:

Close pay in front end, reduce ASW holdings

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.456%	5/4/2009
52 Week T-bills	7/27/2009	-	4.387%	7/13/2009
2Y T-bond OK0112	8/5/2009	-	5.410%	6/3/2009
5Y T-bond PS0414	9/2/2009	-	5.549%	7/15/2009
10Y T-bond DS1019	9/9/2009	-	6.340%	5/20/2009
20Y T-bond WS0429	9/9/2009	-	6.340%	5/20/2009

Money Market

Low short term interbank rates

T-bill's yields down at the tender.

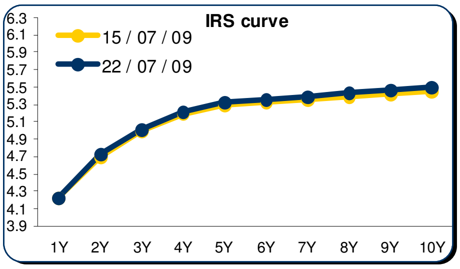
Due to last OMO which was underbid (from 38 billion offer banks bought only 34.7 billion CB bills) short term interbank rates dropped sharply. There is an excess of cash in the system. This week Polonia reached its lowest level ever (2.07 on Monday). Low short term rates will remain until the end of reserve requirement period (30th July). Even tomorrow's tender shouldn't change it.

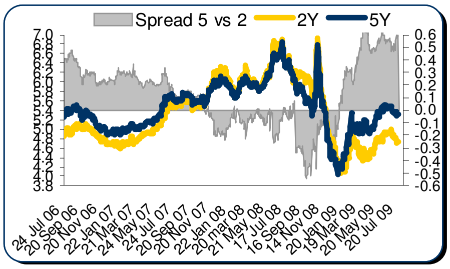
The average yield on Polish 49-week T-bill at primary tender down to 4,276% from 4,387%. Demand was 2.896 billion PLN and the Ministry sold all 997 million papers from the offer.

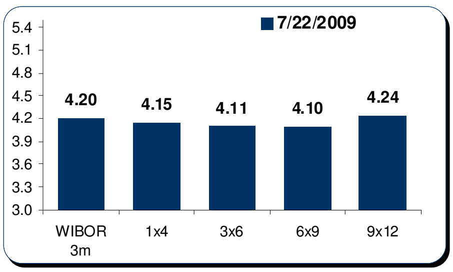
RECOMMENDATION:

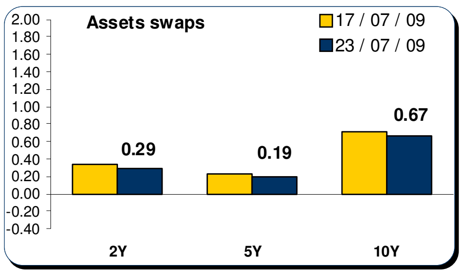
Stay neutral till the end of reserve requirement period

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

This week zloty has opened at 4.3000 and strengthened to 4.2250 low. We still see good sentiment all around us so risk appetite is growing.

Implied volatility bit lower

Stronger zloty on quiet trading pushed EURPLN curve lower with 1M traded at 14.5 and 1Y at 14.0.

RECOMMENDATION:

SPOT

Sell upticks

Main supports / resistances:
EUR/PLN: 4.2100 / 4.4500
USD/PLN: 2.8500 / 3.1100

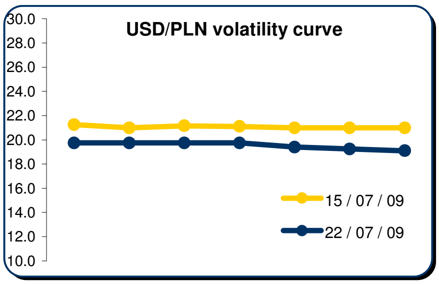
Sell gamma

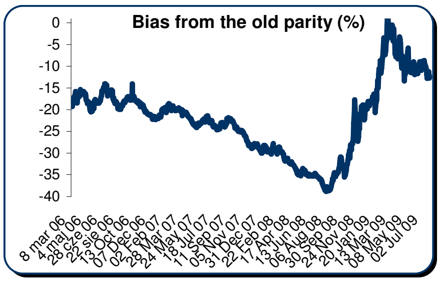
Good sentiment lasts, summer months are quiet, this is perfect environment for stronger PLN. Just lack of inflows makes move slow. Level like 4.40 is desired for PLN long entry.

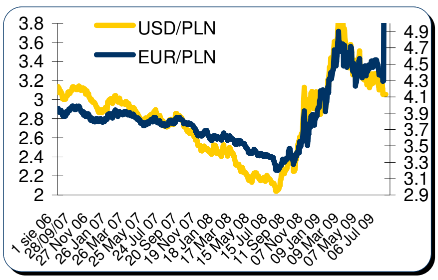
OPTIONS

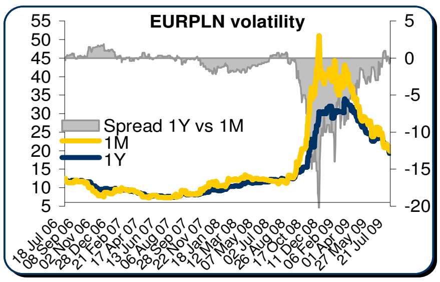
Curve is much lower but we still see chance for short gamma trade to be profitable
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.

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
16/07/09	4.12%	4.29%	4.33%	4.38%	4.53%	4.55%
17/07/09	4.09%	4.27%	4.29%	4.35%	4.49%	6.59%
20/07/09	4.15%	4.22%	4.28%	6.49%	4.48%	4.50%
21/07/09	4.05%	4.21%	4.30%	4.31%	4.50%	4.48%
22/07/09	4.10%	4.20%	4.30%	4.31%	4.44%	4.47%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
16/07/09	4.24%	4.18%	4.18%	4.33%	4.41%
17/07/09	4.19%	4.10%	4.11%	4.26%	4.37%
20/07/09	4.26%	4.10%	4.09%	4.23%	4.35%
21/07/09	4.18%	4.09%	4.08%	4.23%	4.36%
22/07/09	4.14%	4.08%	4.07%	4.22%	4.32%

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
16/07/09	4.55%	4.24%	4.72%	5.01%	5.31%	5.51%	5.47%	6.17%
17/07/09	6.59%	4.29%	4.74%	5.08%	5.32%	5.55%	5.48%	6.20%
20/07/09	4.50%	4.29%	4.73%	5.03%	5.32%	5.52%	5.49%	6.16%
21/07/09	4.48%	4.34%	4.72%	4.98%	5.32%	5.49%	5.50%	6.16%
22/07/09	4.47%	4.27%	4.72%	5.01%	5.32%	5.51%	5.50%	6.17%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/07/06	09/07/06	95.691	4.46%	1200	3254	1200
OK0112	09/07/01	12/01/25	87.362	5.41%	4500	4431	4006
PS0414	09/07/15	14/04/26	100.782	5.55%	2000	6347	2011
DS1017	09/04/08	19/10/25	94.460	6.22%	2500	4846	1820

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
16/07/09	21.00	21.10	21.00	21.00	2.25	4.25	1.25	1.25
17/07/09	20.25	20.00	19.75	19.50	0.00	0.00	0.00	0.00
20/07/09	20.00	19.75	19.50	19.25	0.00	0.00	0.00	0.00
21/07/09	19.75	19.75	19.40	19.25	0.00	0.00	0.00	0.00
22/07/09	19.75	19.75	19.40	19.10	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
16/07/09	3.0527	4.2994	-12.53%
17/07/09	3.0527	5.2994	-12.12%
20/07/09	3.0527	6.2994	-12.48%
21/07/09	3.0527	7.2994	-11.22%
22/07/09	3.0527	8.2994	-12.73%

Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50
Mid-market volatility of vanilla option strategies

Contact Details

BRE BANK SA

Ul. Senatorska 18
00-950 Warszawa
P.O. Box 728
Poland

Reuters Pages: BREX, BREY, and BRET

Bloomberg: BRE

SWIFT: BREXPLPW

www.brebank.pl

Forex (BREX) - FX Spot &Options
Marcin Turkiewicz (+48 22 829 01 84) Marcin.turkiewicz@brebank.pl
Jakub Wiraszka (+48 22 829 01 73)
Tomasz Chmielarski (+48 22 829 01 78)

Fixed Income (BREP) - FRA, IRS, T-Bonds, T-Bills
Łukasz Barwicki (+48 22 829 01 93) Lukasz.barwicki@brebank.pl
Paweł Białczyński (+48 22 829 01 86)

MM (BREP) - MM, FX Swaps
Bartłomiej Małocha (+48 22 829 01 77) Bartlomiej.malocha@brebank.pl
Tomasz Wołosz (+48 22 829 01 74)

Structured Products (BREX)
Jaroslaw Stolarczyk (+48 22 829 01 67) Jaroslaw.stolarczyk@brebank.pl
Jacek Derezinski (+48 22 829 01 69)

Institutional Sales (BRES)
Inga Gaszkowska-Gębska (+48 22 829 12 05)

Research
Ernest Pytlarczyk (+48 22 829 01 66) Research@brebank.pl
Marcin Mazurek (+48 22 829 0183)

Financial Markets Department
Phone (+48 22 829 02 03)
Fax (+48 22 829 02 45)

Treasury Department
Phone (+48 22 829 02 02)
Fax (+48 22 829 02 01)

Financial Institutions Department
Phone (+48 22 829 01 20)
Fax (+48 22 829 01 21)

Back Office
Phone (+48 22 829 04 02)
Fax (+48 22 829 04 03)

Custody Services
Phone (+48 22 829 13 50)
Fax

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