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THE BEST FINANCIAL INSTITUTION FOR DEMANDING CUSTOMERS

*FINANCIAL MARKETS DEPARTMENT*

*PAGES: 8* *WARSAW, JULY 29, 2010*

# POLAND WEEKLY REVIEW

## MACROECONOMICS AND FINANCIAL MARKETS


| | | |
|---|---|---|
| ***IN FOCUS / MACROECONOMICS*** | • *Consumer confidence. June's dip fully erased.* | *• page 2* |
| ***FIXED INCOME*** | • *There is no market. But please read.* | *• page 3* |
| ***MONEY MARKET*** | • *Huge demand on last OMO*<br>• *T-bill's yields down at the tender.* | *• page 4* |
| ***FOREIGN EXCHANGE*** | • *Zloty stronger*<br>• *Implied volatility lower* | *• page 5* |
| ***MARKET PRICES***<br>***CONTACT LIST***<br>***DISCLAIMER*** | | *• page 6*<br>*• page 7*<br>*• page 8* |

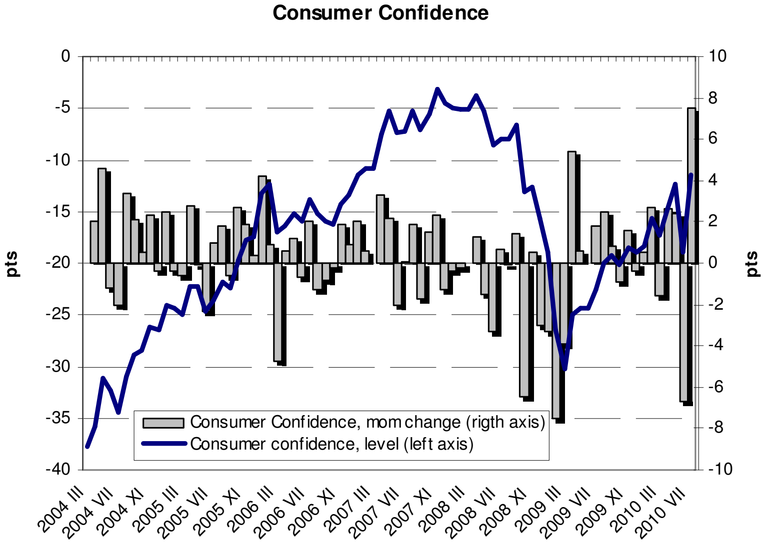

**PREVIEW: The week of July 30th 2010 to August 5th 2010**

| Indicator | Date of release | Period | BRE forecast | Consensus | Last | Comment |
|---|---|---|---|---|---|---|
| **PMI Index** | Aug 2 | Jul | **54.3pts** | - | 53.3pts | Surge in the domestic and foreign business tendency indicators. Export supportive EURPLN. |
| **FinMin's inflation forecast y/y** | Aug 2 | Jul | **2.2%** | - | 2.3% | Food prices above seasonal pattern mainly on fruits and vegetables. Fuel prices relatively stable. Core inflation at 1.2% y/y. |

# In Focus / Macroeconomics

## Consumer confidence. June's dip fully erased.

Solid dip in consumer confidence in June made us thoroughly re-think the perspectives for individual consumption. However, the vision of solid deceleration of consumption, as served by the avalanche in business confidence, stood at odds with 1) fierce growth of mortgage (reflecting broader sentiment within households), 2) dynamic expansion of industrial output (proxy for the and employment (proxy for household incomes). Luckily, consumer confidence was leading astray and it was better to watch the trends in the real data. June's dip in consumer confidence was fully erased in July and the upward trend in this consumption gauge stayed intact.




We expect the recovery in the Polish economy to continue in coming quarters. The growth rate of consumption is set to slowly rise towards 2011, when uncertainty regarding economic outlook dissipates and the process of wealth restoration among consumers (although the exact data is not available, one may expect that savings rate temporary declined as consumption growth was running above the growth of real wages; one should expect to a short- to mid-term reversal of this tendency in the months to come) comes to an end. In the absence of the solid boost from individual consumption the main drivers of GDP growth will be

1) investment (first of all – public, as there are still huge stock of money to be disbursed from EU funds and local authorities are unwilling to cut on spending, then – private, along with bridging the gap between desired and actual capacity utilization),
2) change in inventories (looking at the cycle of inventories relative to GDP it is straightforward that they have just passed the bottom of the cycle and there is still plenty room to go forwards),
3) exports (driven primarily by the cycle in the German economy), although the net exports contributions may stay relatively modest (slightly above 0) on two balancing forces (weak consumption growth relative to industrial output which hampers imports, and high elasticity of imports with respect to exports which is likely to pop at the fore in 2011).

All in all we expect GDP growth in Q2 to reach 3.8% y/y (according to our quite accurate econometric model based on industrial output) on a solid turnaround in investment and high contribution of stocks formation. GDP growth in the whole 2010 is set to rise at least at 3.5% pace.

***MID-TERM FORECATS***

| Indicator | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| GDP y/y (%) | 6.5 | 4.8 | 1.7 | 3.6 | 4.2 |
| Inflation rate (%, average) | 2.4 | 4.3 | 3.5 | 2.6 | 2.9 |
| Current account (% of GDP, average) | -4.5 | -5.3 | -1.6 | -1.8 | -2.9 |
| Unemployment rate (end-of-year) | 11.4 | 9.5 | 11.9 | 12.1 | 10.9 |
| NBP repo rate (end-of-year) | 5.00 | 5.00 | 3.50 | 3.75 | 5.00 |

| Indicator | 2009 | | 2010 | | | |
|---|---|---|---|---|---|---|
| | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| GDP y/y (%) | 1.7 | 3.1 | 3.0 | 3.8 | 4.0 | 4.1 |
| Inflation rate (%, average) | 3.5 | 3.3 | 3.0 | 2.1 | 2.2 | 2.8 |
| NBP repo rate (end-of-quarter) | 3.50 | 3.50 | 3.50 | 3.5 | 3.5 | 3.75 |

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

# Fixed Income

*There is no market. But please read.*

Last week was very quiet on the FI. Rates are almost unchanged from the previous week levels. There was some trading in the bonds, but it changed nothing in the big picture. The main two topics market will be most likely focusing on is budget deficit for 2011 along with the fiscal consolidation plan for next 3 years period, and CPI path. Both will most likely have implications for the decision makers and market participants as well. We kind of fear both.

The discussion that has been going on in the press concentrates rather on what government should do with public finances and how it would make road to euro entry possible. We are very skeptical of that approach. We expect the next budget not to be much different from this year's one. There will be almost no reforms, and the lowering of budget deficit will be done by means of extraordinary measures which are of one-off nature. Political calendar will not permit any big ticket, long-term reforms, not mentioning significant changes in the structure of the budget. Furthermore, we expect the spillover effect to the General Government Deficit to happen in 2010 and 2011 with possibility of debt ratio breaking 55% threshold easily. One can say ok, but does it matter with current risk on sentiment on the market?. Maybe it doesn't right now, but risk on sentiment can change rapidly, while putting public finances in order is not going to happen so fast. Is it going to happen after elections 2011? Such a question can be only left out open tight now…

The other factor is CPI. While some decision makers and market participants as well seem to be rather complacent about CPI developments in the light of recent rising risk of slower economic activity in the developed world, we would like to highlight the local phenomena which can overshadow the consensus view. First of all, the base effects which have been bringing CPI down for the past 6 months are over. Secondly we have unfavorable weather effects which will add to the food prices. Looking at GDP dynamics we estimate at close to 4% level for 2Q and very impressive economic activity in July (industrial output rising towards 14.0%), we are leaning towards the view that monetary policy is right now stimulating economy probably too much (MCI is in rising trend for whole 2010). For us it is just a question of time when those imbalances will start to worry investors. Economy that shows no will to fix public finances and is riding on the loose monetary policy in a phase of rising CPI and growth at potential level is something that bond investors should not be happy about.

***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 | 8/2/2010 | - | 3.976% | 7/26/2010 |
| 2Y T-bond OK0712 | 8/4/2010 | - | 4.740% | 7/7/2010 |
| 5Y T-bond PS0415 | 8/11/2010 | - | 5.373% | 7/14/2010 |
| 10Y T-bond DS1020 | 9/15/2010 | - | 5.790% | 6/16/2010 |
| 20Y T-bond WS0429 | 9/15/2010 | - | 6.170% | 9/23/2009 |

# Money Market

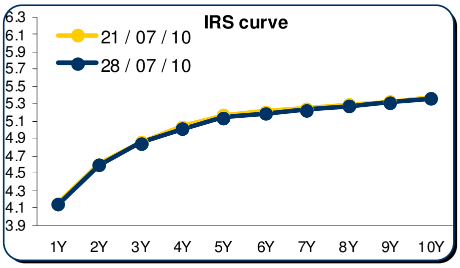
*Huge demand on last OMO*

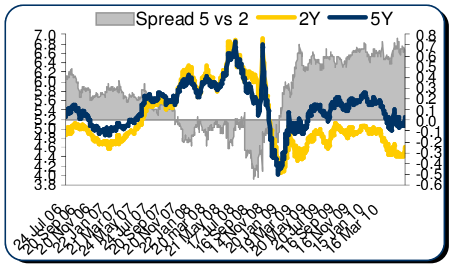
Despite the fact that this is the last week in this reserve requirement period, demand on last Open Market Operation was huge. Central Bank offered PLN 81.3bn bills (which was the biggest offer even seen) and banks demand was even higher – 83.2 bn. This OMO made market square and short-term depo rates increased by over 100 bps and fluctuate around 3% whole week. Tomorrow is the last working day in this reserve requirement period. Therefore we expect banks to be more careful in participating in Central Bank bills tender.

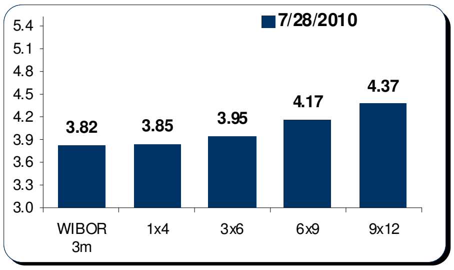
*T-bill's yields down at the tender.*

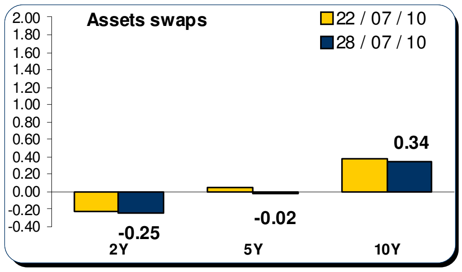
The average yield on Polish 52-week T-bill at primary tender down to 3.976% from 4.025%. Demand was 5.831 billion PLN and the Ministry sold all 1.8 billion papers from the offer.

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



# Foreign Exchange

*Zloty stronger*

This week's EURPLN performance was marked out by Monday's 4.05 top and Thursday's 3.99 low. Good real economy data supported by well performing stocks have increased risk appetite level and has attracted PLN buyers. Previous week's 4.14 levels were faded memories since not top of technical triangle but bottom has been broken. Signal generated by breaking of 4.0750 support has drove EURPLN to mentioned above lows. Highest correlated benchmarks are, invariably, EURUSD, EURJPY, S&P (respectively -0.85, -0.8, -0.5)

*Implied volatility bit lower*

Stronger Zloty and low realized volatility (Thu-Thu – 11.15% and Mon-Thu 6.75%) has created pressure for lower implied vols. Monday's opening curve pointed by 1M ATM 11.6, 3M 12.25 and 1Y 12.75 has lowered to: 1M 11.4, 3M 12.0 and 1Y 12.7. Although decrease does not look spectacular it is needed to mention that gap between implied and realized volatility (especially short end) systematically narrows. Market simply prices lower chances of next "crisis" scenarios. Smile reaction was more noticeable, 3M 25D EURPLN RR benchmark lowered from 3.5 to 3.0. EURPLN vs USDPLN currency spread is traded (with lower EURUSD vols) lower, at 6.75, level.

***Short-term forecasts:***

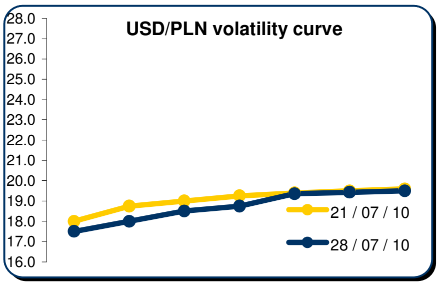
SPOT
Main supports / resistances:
EUR/PLN: 3.9400 / 4.0700
USD/PLN: 3.0000 / 3.1400

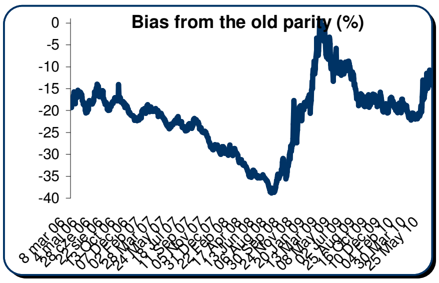
On one hand we see 3.94 as a target of this move (if risk appetite will last of course) but on the other hand potential dynamics of it we see as low. Wait and sell spikes then.

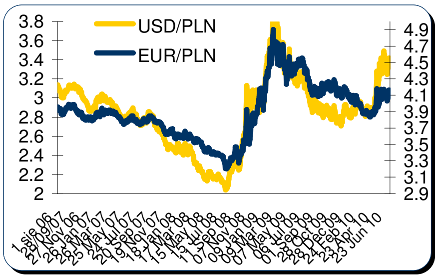
OPTIONS

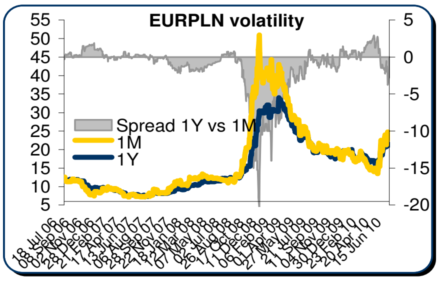
Current underlying performance is likely to push implied volatility lower, aiming this year lows level. We lower our bids and still play vega range slightly more eager to sell on upticks.

***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 |
| 22/07/10 | 3.73% | 3.82% | 3.90% | 3.89% | 4.15% | 4.15% |
| 23/07/10 | 3.70% | 3.82% | 3.92% | 3.89% | 4.10% | 6.59% |
| 26/07/10 | 3.69% | 3.81% | 3.79% | 6.49% | 4.08% | 4.13% |
| 27/07/10 | 3.75% | 3.82% | 3.88% | 3.89% | 4.10% | 4.14% |
| 28/07/10 | 3.69% | 3.82% | 3.83% | 3.89% | 4.08% | 4.14% |

### FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

| date | 1X4 | 3X6 | 6X9 | 9X12 | 6X12 |
|---|---|---|---|---|---|
| 22/07/10 | 3.86% | 3.98% | 4.19% | 4.40% | 4.38% |
| 23/07/10 | 3.84% | 3.98% | 4.20% | 4.40% | 4.38% |
| 26/07/10 | 3.86% | 3.96% | 4.18% | 4.38% | 4.35% |
| 27/07/10 | 3.86% | 3.97% | 4.18% | 4.38% | 4.35% |
| 28/07/10 | 3.85% | 3.96% | 4.18% | 4.39% | 4.37% |

### FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)

| date | 1Y | | 2Y | | 5Y | | 10Y | |
|---|---|---|---|---|---|---|---|---|
| | WIBOR | TB | IRS | OK0112 | IRS | PS0511 | IRS | DS1017 |
| 22/07/10 | 4.15% | 3.98% | 4.59% | 4.36% | 5.15% | 5.19% | 5.36% | 5.74% |
| 23/07/10 | 6.59% | 3.98% | 4.61% | 4.37% | 5.15% | 5.18% | 5.36% | 5.74% |
| 26/07/10 | 4.13% | 3.98% | 4.61% | 4.36% | 5.16% | 5.15% | 5.37% | 5.71% |
| 27/07/10 | 4.14% | 3.98% | 4.59% | 4.36% | 5.13% | 5.15% | 5.34% | 5.71% |
| 28/07/10 | 4.14% | 3.98% | 4.59% | 4.34% | 5.14% | 5.12% | 5.36% | 5.70% |

### PRIMARY MARKET RATES

Last Primary Market Rates

| | au. date | maturity | avg price | avg yield | supply | demand | sold |
|---|---|---|---|---|---|---|---|
| 52W TB | 10/07/26 | 11/07/26 | 96.135 | 3.98% | 1800 | 5831 | 1800 |
| OK0712 | 10/04/07 | 12/07/25 | 89.301 | 4.54% | 3000 | 6726 | 2999 |
| PS0415 | 09/07/14 | 15/04/25 | 100.483 | 5.37% | 3000 | 2807 | 2027 |
| DS1019 | 10/06/16 | 19/04/25 | 95.807 | 5.79% | 3000 | 2965 | 2430 |

### FX VOLATILITY

| | USD/PLN 0-delta stradle | | | | 25-delta RR | | 25-delta FLY | |
|---|---|---|---|---|---|---|---|---|
| date | 1M | 3M | 6M | 1Y | 1M | 1Y | 1M | 1Y |
| 22/07/10 | 18.75 | 19.25 | 19.40 | 19.60 | 4.00 | 5.00 | 0.75 | 0.95 |
| 23/07/10 | 18.00 | 19.00 | 19.25 | 19.50 | 3.75 | 5.25 | 0.75 | 0.95 |
| 26/07/10 | 18.00 | 19.00 | 19.25 | 19.50 | 3.75 | 5.25 | 0.75 | 0.95 |
| 27/07/10 | 18.00 | 19.00 | 19.25 | 19.50 | 3.75 | 5.25 | 0.75 | 0.95 |
| 28/07/10 | 18.00 | 18.85 | 19.25 | 19.50 | 3.75 | 5.15 | 0.75 | 0.95 |

### PLN SPOT PERFORMANCE

PLN spot performance

| date | USD/PLN | EUR/PLN | bias |
|---|---|---|---|
| 22/07/10 | 3.1945 | 4.1007 | -15.07% |
| 23/07/10 | 3.1383 | 4.0633 | -14.47% |
| 26/07/10 | 3.1373 | 4.0472 | -14.59% |
| 27/07/10 | 3.0861 | 4.0125 | -15.45% |
| 28/07/10 | 3.0756 | 4.0006 | -15.65% |

*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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