



TOP NEWS FROM THE POLISH MARKET

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- Zloty stronger
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MACROECONOMICS

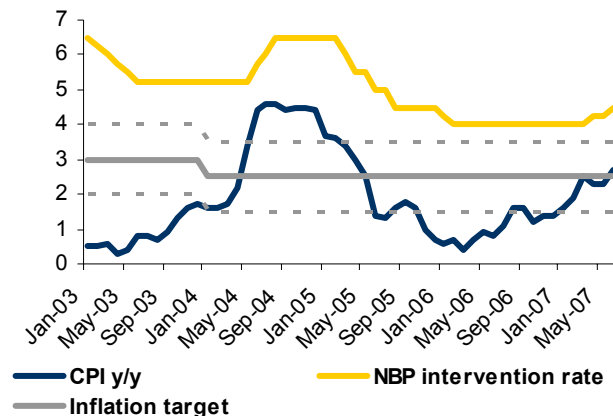
The Ministry of Finance forecasts inflation in June at 2.7%

We expect the annual CPI at the end of the year at 3.2%

The MPC member M.Noga expects only one more hike this year which stays below market and our expectations

The inflation is still growing. Do the MPC continue the tightening cycle?

The Ministry of Finance published the inflation forecast for June at 2.7%. This figure was in line with our expectations and shows that inflationary pressure has risen. Such a significant growth of annual inflation as compared with May (2.3%) has been caused mostly by a lower than normal drop in food prices. We expect CPI at the end of this year to be at 3.2%. However food prices are not the only factor pushing up the inflation. Due to strong domestic demand and growing unit labour costs the core inflation is growing as well. The Ministry of Finance has not published the core inflation forecast but according to our estimates the core inflation (excl. food and oil) grew in June to 1.7% from 1.6% in May. It is still below the inflation target (2.5%) but the upward trend on the core inflation is rather strong and within one year the target could be exceeded. It is noteworthy that June was the first month for 2 years when the CPI inflation exceeded the inflation target. Thus contrary to the years 2004/2005 when inflation increased temporarily due to EU accession shock, the current growth of CPI seems to be permanent and has been followed by growing wages pressure. The low level of unemployment increases the risk of so called "second round effects", when the growth of inflationary expectations may lead to stronger wages pressure and by growth of unit labour costs result in higher inflation. It may be a key argument for the MPC to hike the rates despite of the fact that core inflation still remains below the target.



Source: GUS, NBP, BRE Bank

The MPC's first response to the Ministry forecast was rather dovish. The MPC member Marian Noga said that anchoring the inflation at the target may need one more hike this year and at least one hike in the next one. The scale of tightening suggested by Prof. Noga is below our and market expectations. The MPC member has revealed the timing of the next hike as well. He said that "the moment of tightening will depend on the relation between wages and productivity and on how deep the inflation drops in August and September [due to favourable base effect]". It means that Prof. Noga would opt for October as a date for the next hike.

Prof. Noga mentioned two issues, which may be very important for forecasting the future path of interest rates. Firstly he said that in the MPC's opinion in the next several quarters GDP will be strong and the expected lower growth rate of industry output followed by high growth of wages and employment will be interpreted mostly as a deterioration of the productivity/wages ratio and an increase of unit labour cost. It means that the MPC will interpret deterioration of industry

We expect a 100 bps hike in the next 12 months

The unemployment rate may drop to 12.4% in June and to 10.0% at the end of the year

Low unemployment will increase the pressure on wages

output growth as pro rather than anti-inflationary, which increases the likelihood of hikes in the coming months.

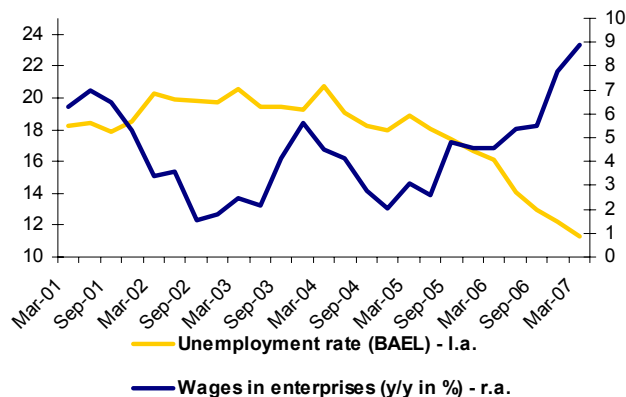
Secondly Prof. Noga said that one of the key factors for the MPC is the exchange rate. It clearly indicates that the crucial factor, which stops more aggressive tightening by the MPC is the threat against zloty appreciation.

We think that after strong data for wages and inflation in June the comments of MPC members will be more hawkish. We maintain our scenario of hikes by 100 bps in the next 12 months with the repo rate at 5.00% at the end of 2007 and 5.50% by mid of 2008.

Strong labour market may increase wages pressure

According to the Ministry of Labour the unemployment rate in June dropped to 12.4%. It is not the official data, which will be published by GUS (Central Statistical Office) on the 24th of July, but the official data is derived from the MoL calculation so the difference cannot be large. The drop in unemployment is higher than we expected and results mostly from two factors: the growing employment (3.0% y/y in Q1) and emigration to "old" EU countries. The Ministry estimates that the unemployment rate at the end of this year may drop below 10%, which in our opinion is not very likely. It is noteworthy that in the previous year the level of unemployment in November-December was strongly influenced by favourable weather conditions, which may not be the case this year. Moreover the Parliament voted in a new act which limits the trade on national holidays. That is why we believe that the unemployment rate at the end of year will be slightly higher at 10.5-10.6%.

It is noteworthy that the official statistics may be upside biased. Eurostat estimated the unemployment rate in Poland in May at 10.5% (official unemployment rate 13.0%). On the other hand the poll survey (BAEL) indicates that unemployment rate is ca. 3% lower than official statistics show. In Q1 the BAEL unemployment rate amounted to 11.3%, while the official statistics showed 14.4%.



Source: GUS, NBP, BRE Bank

We think that despite methodology the true unemployment rate is near the natural rate of unemployment (NAWRU), which will lead to stronger wages pressure. We observe that the wages growth in the enterprises sector accelerated in the last six months from 5.5% y/y in 2006 Q4 to 8.9% in 2007 Q2. We expect that in the coming months we will see a double digit growth in wages which, due to lower productivity growth, will increase the inflationary pressure.

FIXED INCOME

Very interesting week, with panic the main market driver

Last week was quite interesting on the PLN IR market. We saw some panic reaction, nice volatility and big volumes going through, all without any fundamental reason. The most impressive move we saw in short term FRA which moved up by more than 12 bps over the week. The payers of the short FRA curve were mainly local banks, we think at least part of this flow was stop-loss related, as more the volume than the rate mattered. The correction surprisingly was caused by 'dovish speech of usually hawkish member of MPC Prof. Noga, who suggested possibility of delaying hikes long into 4th quarter of the year. We look forward to bigger volatility as removing or pricing hike into July seems to be the biggest market driver. Market looks very uncertain with the view while positions which have been built are quite heavy (especially after Thursday's 2y IRS action). We remain on the sidelines, and recommend playing against big moves. We also suggest taking profit on flatteners, we like 1y against 2y steepener, as we still think 1y3s is very overdone due to very high cash rate in 3M (currently 4.78).
Good Luck.

RECOMMENDATION:

Use market volatility, pay 1y2y spread.

MONEY MARKET

Stable carry next week

Stable week for the carry as it is just the beginning of the reserve requirement settlement period. Open market operation PLN bn 22.9 was to square the market, but the market bought less (PLN bn 21.3). It becomes the rule that the market is more careful as far as system liquidity is concerned. This is the price the central bank pays for war with the meaningless reduction ratio. Even though there will be slight surplus of the cash in the system, we do not think any drop in the shortest rates will occur.

Bearish CPI forecast by the MinFin

As for longer terms much more interesting week behind. CPI forecast by the MinFin shows the 2.7% figure which is above the lower inflation band guarded by the central bank. Even though it was quite expected, the market took it bearish. Market started July hike play. However, on Wednesday one of the hawkish MPC members said that only one more hike may be needed this year to fight back inflation. Bullish was triggered and supported by some stop losses. Market became a mess.

Bullish statement by the hawkish MPC member

We see 2 more hikes this year and 2 more first half of the year 2008. July hike probability 50%.

Lots of volatility

RECOMMENDATION:

Sell Polonia if prices discount more than 4 hikes in a year time.

FOREIGN EXCHANGE

Zloty stable

Last week the Zloty traded range-bound between 3.7450 and 3.7800. Testing of significant support at 3.7500 resulted from market's mounting expectations regarding the rate hike. With EUR/USD not any more so volatile, USD/PLN also traded range-bound 2.7500 – 2.7800.

Volatility stable

Implied volatilities traded more or less at the same levels than a week before: the 1M EUR/PLN traded at 6.05, whereas 1Y at 6.15, both mids. The USD/PLN volatility curve traded also a touch lower at 7.25 (1M) and 7.5 (1Y).

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/USD: 1.3500 / 1.3700
EUR/PLN: 3.7500 / 3.7750
USD/PLN: 2.7500 / 2.7900

Zloty stronger

In the following week we may see EUR/PLN test the 3.7500 level again, that is why we recommend selling EUR/PLN on tops in the following week.

Options:

Short Gamma

Implied volatilities still seem to trade rich relative to historical realized ones (especially in 3M tenor), that is why, in the absence of expectations of large and sudden spot moves, we recommend selling Gamma and earning the decay the following week.

MARKET PRICES UPDATE**MONEY MARKET RATES**

Money market rates (Closing mid-market levels)						
date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
02-07-07	4.68%	4.74%	4.89%	4.88%	5.24%	5.18%
03-07-07	4.68%	4.74%	4.89%	4.88%	5.24%	5.18%
04-07-07	4.73%	4.77%	4.90%	4.95%	5.24%	5.26%
05-07-07	4.73%	4.77%	4.90%	4.94%	5.25%	5.25%
06-07-07	4.74%	4.78%	4.91%	4.95%	5.27%	4.79%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
	02-07-07	4.85%	5.08%	5.36%	5.53%
03-07-07	4.90%	5.11%	5.43%	5.59%	5.54%
04-07-07	4.88%	5.06%	5.39%	5.52%	5.48%
05-07-07	4.87%	5.06%	5.36%	5.55%	5.49%
06-07-07	4.87%	5.07%	5.37%	5.57%	5.49%

FIXED INCOME MARKET RATES

Fixed Income Market Rates (Closing mid-market levels)								
date	1Y		2Y		5Y		10Y	
	WIBOR	TB	IRS	OK1208	IRS	PS0511	IRS	DS1017
02-07-07	5.18%	4.52%	5.50%	4.95%	5.69%	5.57%	5.70%	5.62%
03-07-07	5.18%	4.57%	5.56%	5.00%	5.71%	5.54%	5.70%	5.64%
04-07-07	5.26%	4.60%	5.55%	5.03%	5.71%	5.52%	5.70%	5.62%
05-07-07	5.25%	4.60%	5.55%	5.06%	5.71%	5.53%	5.71%	5.63%
06-07-07	4.79%	4.60%	5.54%	5.03%	5.72%	5.56%	5.73%	5.65%

PRIMARY MARKET RATES

Last Primary Market Rates							
	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	07-06-04	08-06-04	95.759	4.38%	500	1931	500
OK0709	07-04-04	09-07-25	89.970	4.69%	1000	2463	1000
PS0412	07-06-22	12-04-25	96.925	5.48%	1000	2673	1000
DS1017	07-04-11	17-10-25	99.976	5.24%	1800	3473	1800

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
02-07-07	7.30	7.30	7.50	7.65	0.90	1.15	0.30	0.45
03-07-07	7.30	7.30	7.50	7.65	1.25	1.20	0.30	0.40
04-07-07	7.30	7.30	7.50	7.65	1.25	1.20	0.30	0.40
05-07-07	7.30	7.30	7.50	7.65	1.25	1.20	0.30	0.40
06-07-07	7.30	7.30	7.50	7.65	1.25	1.20	0.30	0.40

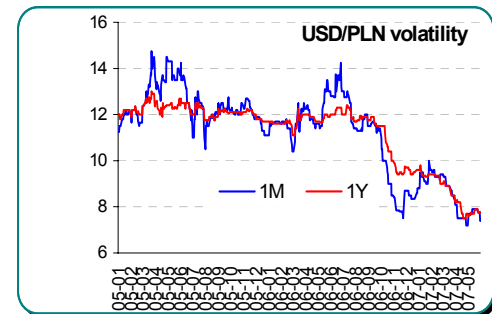
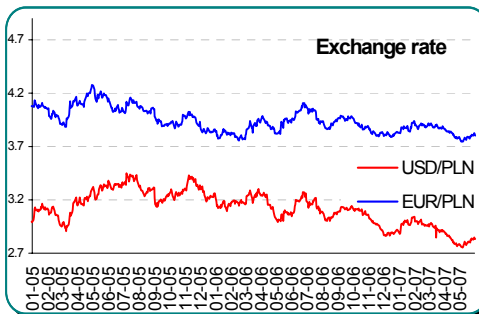
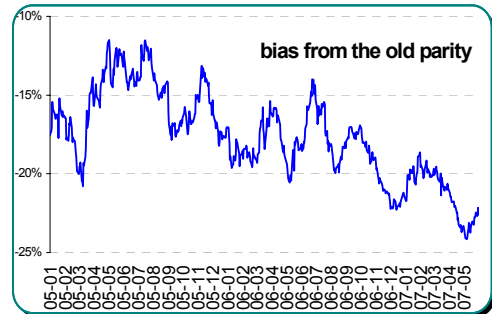
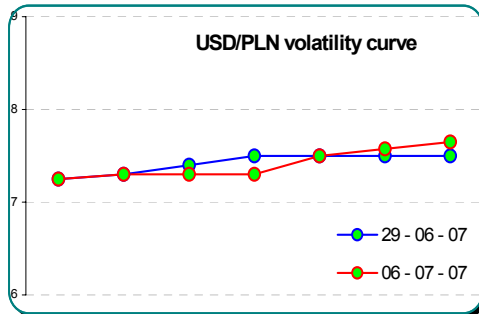
PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
02-07-07	2.7695	3.7598	-23.84%
03-07-07	2.7625	3.7578	-23.94%
04-07-07	2.7622	3.7609	-23.91%
05-07-07	2.7593	3.7647	-23.90%
06-07-07	2.7755	3.7730	-23.61%

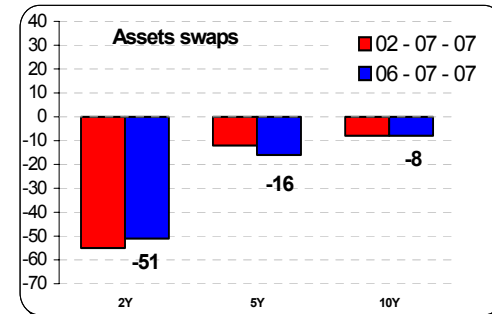
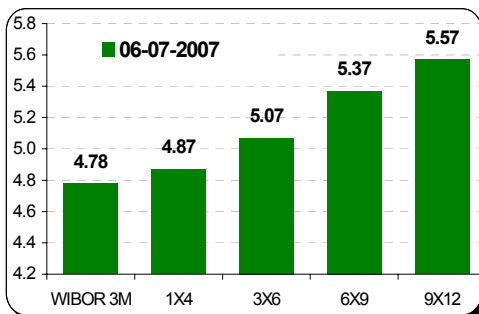
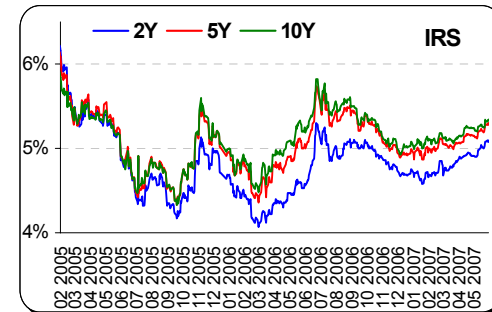
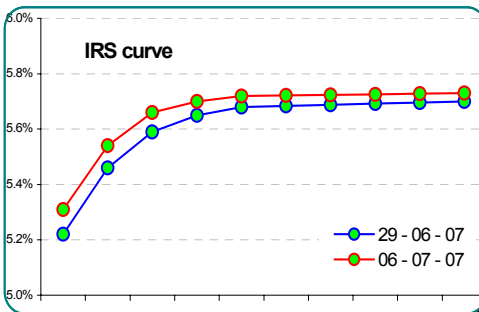
Note: parity on 11/04/00 – USD= 4.3806, EUR=4.2196, basket share 50:50
Mid-market volatility of vanilla option strategies

CHARTS

Foreign Exchange



Fixed Income



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CALENDAR

Macro

	April	May	June	Data Release	BRE Bank forecast
CPI m/m	0.5%	0.5%		13-07-07	0.0%
CPI y/y	2.3%	2.3%		13-07-07	2.7%
PPI m/m	0.5%	0.4%		19-07-07	0.5%
PPI y/y	2.3%	2.2%		19-07-07	1.6%
Industrial production growth m/m	-8.6%	3.0%		19-07-07	1.8%
Industrial production growth y/y	12.6%	8.1%		19-07-07	7.3%
Average wages in enterprise sector [PLN]	2786.3	2776.9		16-07-07	2871.3
Average wages in enterprise sector y/y	8.4%	8.9%		16-07-07	9.4%
Unemployment	13.7%	13.0%		24-07-07	12.5%
Budget realisation (%)	6.9%	14.2%		13-07-07	12.9%
Current account [EUR mn]	-678			13-07-07	-715
Balance of foreign trade in goods (transaction basis) [EUR mn]	-779			13-07-07	-885
Exports growth y/y (transaction basis)	15.7%			13-07-07	12.0%
Imports growth y/y (transaction basis)	24.9%			13-07-07	15.8%
Current account [% of GDP]	-2.2%			13-07-07	-2.2%
Money supply (M3)	498.4	502.9		13-07-07	507.9
Money supply growth y/y	17.8%	16.1%		13-07-07	16.0%
Total PLN loans [PLN bn]	402.6	412.5		13-07-07	
Households PLN loans	209.4	216.9		13-07-07	
Corporate PLN loans	155.3	156.9		13-07-07	
Total PLN deposits [PLN bn]	414.0	417.2		13-07-07	
Households PLN deposits	225.0	222.7		13-07-07	
Corporate PLN deposits	126.7	129.1		13-07-07	
NBP intervention rate	4.25%	4.25%	4.50%	25-07-07	4.75%

Auctions

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4.208%	16-01-06
26 Week T-bills	-	-	3.943%	24-04-06
52 Week T-bills	09-07-07	500	4.380%	04-06-07
2Y T-bond OK1208	01-08-07	-	4.694%	04-04-07
5Y T-bond PS0412	19-09-07	-	5.480%	20-06-07
10Y T-bond DS1017	11-07-07	-	5.244%	11-04-07
20Y T-bond WS0922	12-09-07	-	5.309%	14-03-07

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