



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of August 24th to August 29th

| Indicator | Date of release | Period | BRE forecast | Con-sensus | Last | Comment |
|--------------------------------|-----------------|--------|--------------|------------|-------|--|
| Retail sales | Aug 25 | July | 15.5% | 16.0% | 16.2% | In line with the underlying trend. The last figure has been distorted by an extraordinary rise in the sales of motor vehicles. |
| MPC decision on interest rates | Aug 29 | Aug | 4.75% | 4.75% | 4.5% | Global market turbulences and rising risk aversion may adversely impact the zloty and threaten price stability in the Polish economy. So, we do not expect them to restrain the MPC to hike the rates. |

In Focus / Macroeconomics

Industry output is growing at a slower rate than in Q1 but GDP growth should remain strong

Polish economy comes to the point where growing ULC may affect retail prices

Despite weaker industry output in Q2 we expect GDP growth to remain strong

Recent data confirmed that the Polish economy remains in a recovery phase. Industry output increased by 10.4% y/y in July, compared with 5.6% y/y in June. It is worth noting that higher annual growth results from a more favourable trading-day effect. After a trading-day effect adjustment, industry output grew by 8.3% y/y in July - which is very similar to the 8.0% y/y recorded in June. The average growth rates for industry output in the second and third quarters are lower than in Q1 – although, in our opinion, such figures allow the GDP to achieve growth in the region of 5-6%.

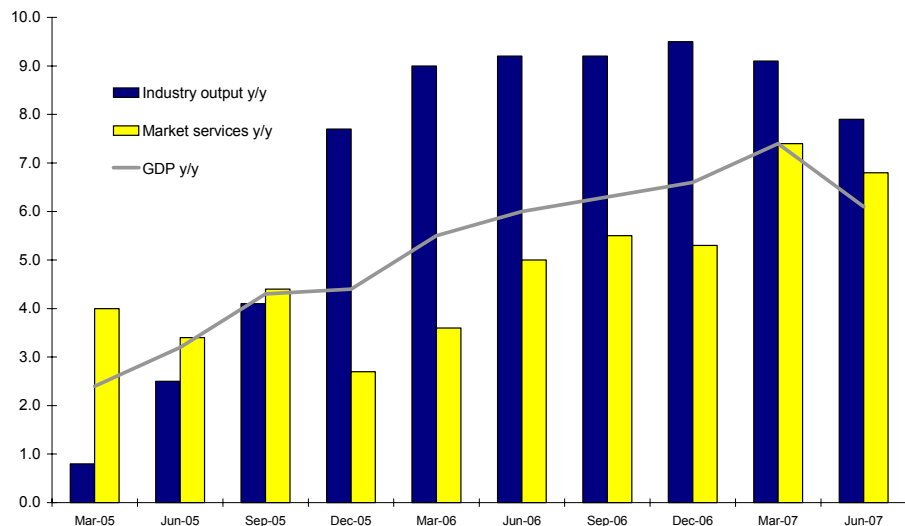
During last year, there were significant changes in the contribution to GDP growth. Since the beginning of 2006 we have observed an increasing contribution from market services to GDP growth. In Q1 2006 the dynamics of market services were equal to 3.6%, while in Q1 2007 they amounted to 7.4% y/y. On the other hand, the growth of gross value in industry remained unchanged at ca. 9.0%. The more rapid growth of market services has been followed by strong growth in retail sales. We anticipate retail sales increasing by 15.5% in July.

For this reason, we believe that the economy will develop over the next few quarters at a growth rate of 5-6%. On Wednesday the GUS will publish data for Q2 2007. We expect that GDP growth in Q2 amounted to 6.1% while private consumption increased by 6.5%. In Q3 we estimate GDP growth at 5.8%.

However, the less significant growth in industry output combined with strong wage dynamics indicate that the economy is coming to the point where growing unit labour costs impact on retail prices.

Net inflation fell in July to 1.5% - caused solely by a favourable base effect. We assert that it will grow to 2.0% by the end of this year and to 2.5% by the middle of 2008.

We consider that the MPC is aware of this danger and will continue to tighten monetary policy.



Polish MPC likely to hike the rates at its August meeting

Although there are increased risks that the ECB will postpone a rate hike and the FED is likely to lower rates in due course, the Polish MPC seems to consider domestic factors such as rising wage pressure and the weakening zloty of greater importance. That is why, we expect the Committee to continue with its policy of monetary tightening and, in line with market expectations, a rate hike in August.

Global market turbulences and rising risk aversion may adversely impact the zloty and threaten price stability in the Polish economy. So, we do not expect them to restrain the MPC to hike the rates.

Over the course of previous week we scrutinized comments from MPC members: Wasilewska-Trenkener, Czekaj, Noga, Filar and Owsiak. The first four members have clearly indicated that they are increasingly concerned about the rising wage pressures and mounting inflation risks. Filar, a hawkish MPC member, seemed to share our view that lower economic growth rates anticipated in Poland would do little to dampen the bargaining power of workers and consequently wage pressure would increase in the coming months. Filar envisages inflation topping 2.9% this year and expects the Committee to hike the rates by a total of 100 bps by mid 2008 to prevent inflation breaching the 3.5% mark, an upper band of the inflation target. Noga expressed a very similar opinion. Czekaj - a key MPC member according to our assessment of the balance of powers within the Committee - agrees that interest rate hikes are indeed very likely unless some form of unexpected shock were to affect the economy.

In his opinion, the high rates of economic growth will be sustained throughout the next few quarters, which in turn will lead to economic turmoil. MPC members do not seem particularly concerned about turbulence in the global financial markets and its implications for economic growth in Poland or the outlook on inflation. We also gauge that this turmoil will impact on the rate decision unambiguously: on the one hand, falling share prices in global - as well as on the local - stock exchanges (given the recent popularity in investment Polish shares) may induce some 'wealth effect' possibly restraining the growth in consumption. Wasilewska-Trenkner, in making explicit references to the global market turbulences, stated, however, that rising risk aversion may adversely impact on the zloty and threaten price stability in the Polish economy. We think that for emerging economies, such as Poland, this second effect will dominate the economist's view. As the situation on the financial markets stabilised during the past few days, we expect that arguments supporting postponement of the rate cut to have less significance on the upcoming meeting than they seemed to have only few days ago.

MEDIUM-TERM FORECATS

| Indicator | 2006 | 2007 | 2008 |
|---------------------------------|------|-------------|------------|
| GDP y/y (%) | 6,1 | 6,2 | 5,7 |
| Inflation rate (%) | 1,0 | 2,4 | 3,2 |
| Current account (% of GDP) | -2,1 | -4,0 | -4,8 |
| Unemployment rate (end-of-year) | 14,9 | 10,3 | 9,8 |
| NBP repo rate (end-of-year) | 4,00 | 5,00 | 5,50 |

Source: GUS, NBP, BRE Bank, **bold** change on last week

Fixed Income

Yields reaching new highs

Last week appeared more volatile than we expected with rates climbing up. Slightly lower inflation reading published on Tuesday (2.3% y/y vs. 2.4% forecasted) was only enough to cause just temporary strengthening and already next day rates jumped up again by some 8 bp and the curve has also steepened quite significantly. Economic data and recent MPC members' comments suggest that 25bp rate hike this month is very likely. This, however seems to be fully priced in by the market and therefore shouldn't be followed by any strong reaction. Yields on POLGB's have reached levels which start to be considered attractive by some players, and we start observing some demand there. However we think that the trend is still up and this demand isn't enough to counteract the sharp, weakening moves we're observing. In these circumstances, taking pay positions on lows and squaring it few bp higher seems a safer strategy than otherwise. We recommend taking some profit on the steepeners and using lows to pay swaps.

RECOMMENDATION:

Pay dips. Reduce steepeners.

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 | 03-09-07 | - | 4,816% | 06-08-07 |
| 2Y T-bond OK1209 | 05-09-07 | - | 5,185% | 01-08-07 |
| 5Y T-bond PS0412 | 19-09-07 | - | 5,480% | 20-06-07 |
| 10Y T-bond DS1017 | 10-10-07 | - | 5,658% | 11-07-07 |
| 20Y T-bond WS0922 | 12-09-07 | - | 5,309% | 14-03-07 |

Money Market

Carry lower and lower

Cheap end of the reserve very likely

Fed made bad sentiment disappear but probably only for a while

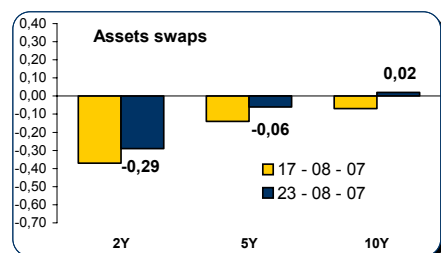
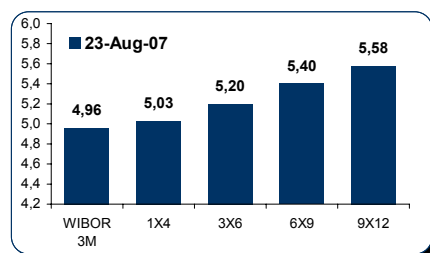
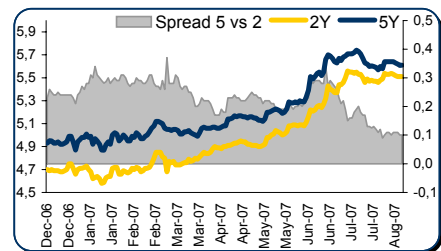
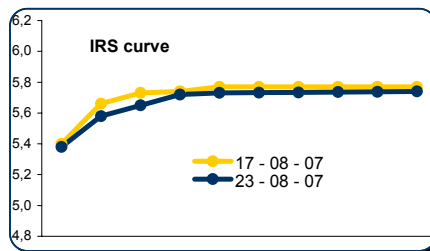
Cost of carry lower and lower because of the reasons we mentioned in our last weekly. Moreover the market again did not absorb the full size of the open market operation (19 billion pln on bid vs 19.7 billion pln on offer). It is quite odd since everyone knew that shortest rates will fall if it happened. That makes our forecast for tomorrow's auction a bit difficult. We think that open market operation should be around 22-23 billion pln to avoid shortest rates from falling to deposit rate during the last day of the reserve, which is next Thursday. The question is whether the market will buy it all? If not or if the operation is smaller very cheap week ahead.

Longer terms supported strongly by FED. Stock exchanges recovered promptly after the decision and visions of soon disaster disappeared. In our opinion this is just postponing of what is inevitable, hence we recommend any bullish movement to be used for taking pay position. Moreover some comments from the MPC members showed last week that there is a will for further tightening. We bet on another hike as soon as next week.

Pay on dips.

RECOMMENDATION:

FIXED INCOME & MONEY MARKET CHARTS



Foreign Exchange

Zloty weaker

This week zloty was traded between 3.8220 and 3.8550 and was driven by bad global sentiment with enormous huge buying on 21st and 22nd of August. Market looks short PLN and breaching the upper bound of a range lowered its likelihood. Anyway, till global market won't digest US subprimes and sentiment get much warmer breaking of 3.8050 is also not likely.

Volatility mixed

Implied volatility for 1M was traded between 6.9 up to 6.25 and from 6.2 to 5.85 for 1Y. Trades

at 1Y below 6.0 gives signals for trades on lower levels on short tenors.

RECOMMENDATION:

RECOMMENDATION:

Spot:
 Main supports / resistances:
 EUR/PLN: 3.8050 / 3.8500
 USD/PLN: 2.7950 / 2.9000

Zloty in side trend

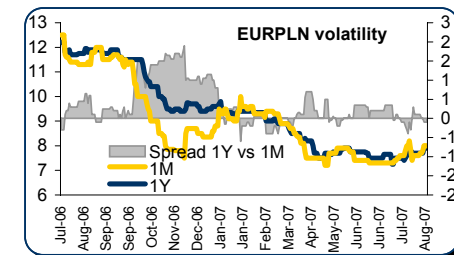
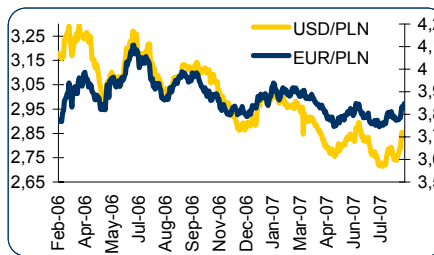
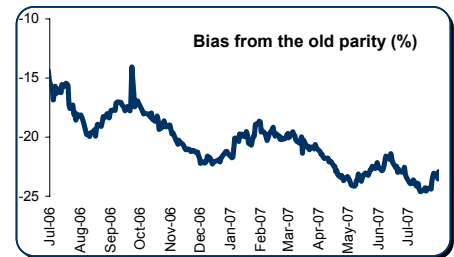
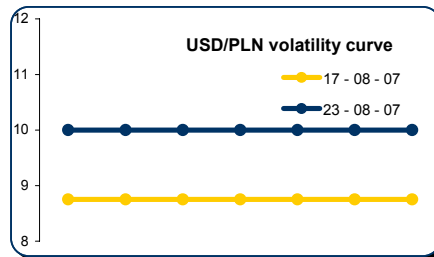
We see zloty in side trend, so we will be 3.8600 offerers. We also advice to stay careful around 3.8050 levels as probability of breaking 3.8000 is a little bit higher in coming week.

Options:

Keep short vega

As trades on 1Y above 6.00 looks like melody of the past at the moment and on the other hand sentiment didn't improve to convince us to sell at present levels we advice to keep opened positions at higher levels and not to open new vega shorts.

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 |
| 17-08-07 | 4,83% | 4,92% | 4,99% | 5,11% | 5,27% | 5,37% |
| 20-08-07 | 4,86% | 4,93% | 5,01% | 5,11% | 5,31% | 5,37% |
| 21-08-07 | 4,86% | 4,93% | 5,01% | 5,11% | 5,31% | 5,37% |
| 22-08-07 | 4,85% | 4,95% | 5,01% | 5,14% | 5,30% | 5,40% |
| 23-08-07 | 4,91% | 4,96% | 5,05% | 5,15% | 5,32% | 5,42% |

FRA MARKET RATES

| FRA Market Rates (Closing mid-market levels) | | | | | |
|--|-------|-------|-------|-------|-------|
| date | 1X4 | 3X6 | 6X9 | 9X12 | 6X12 |
| 17-08-07 | 5,01% | 5,18% | 5,40% | 5,59% | 5,54% |
| 20-08-07 | 5,02% | 5,20% | 5,42% | 5,61% | 5,56% |
| 21-08-07 | 5,03% | 5,20% | 5,41% | 5,61% | 5,55% |
| 22-08-07 | 5,03% | 5,19% | 5,42% | 5,60% | 5,53% |
| 23-08-07 | 5,03% | 5,20% | 5,40% | 5,58% | 5,53% |

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 |
| 17-08-07 | 5,37% | 4,94% | 5,65% | 5,28% | 5,75% | 5,61% | 5,76% | 5,69% |
| 20-08-07 | 5,37% | 4,94% | 5,61% | 5,30% | 5,75% | 5,68% | 5,75% | 5,76% |
| 21-08-07 | 5,37% | 4,95% | 5,65% | 5,32% | 5,76% | 5,71% | 5,76% | 5,79% |
| 22-08-07 | 5,40% | 4,92% | 5,60% | 5,29% | 5,74% | 5,69% | 5,75% | 5,79% |
| 23-08-07 | 5,42% | 4,90% | 5,58% | 5,29% | 5,73% | 5,67% | 5,74% | 5,76% |

PRIMARY MARKET RATES

| Last Primary Market Rates | | | | | | | |
|---------------------------|----------|----------|-----------|-----------|--------|--------|------|
| | au. date | maturity | avg price | avg yield | supply | demand | sold |
| 52W TB | 07-07-09 | 08-07-09 | 95,357 | 4,82% | 500 | 1114 | 500 |
| OK0709 | 07-08-01 | 09-07-25 | 90,485 | 5,19% | 2000 | 2084 | 1399 |
| PS0412 | 07-06-22 | 12-04-25 | 96,925 | 5,48% | 1000 | 2673 | 1000 |
| DS1017 | 07-07-11 | 17-10-25 | 96,817 | 5,66% | 1800 | 2997 | 1800 |

FX VOLATILITY

| date | USD/PLN 0-delta stradle | | | | 25-delta RR | | 25-delta FLY | |
|----------|-------------------------|------|------|------|-------------|------|--------------|------|
| | 1M | 3M | 6M | 1Y | 1M | 1Y | 1M | 1Y |
| 17-08-07 | 9,25 | 8,70 | 8,50 | 8,35 | 1,30 | 1,10 | 0,30 | 0,35 |
| 20-08-07 | 9,25 | 8,70 | 8,50 | 8,35 | 1,30 | 1,10 | 0,30 | 0,35 |
| 21-08-07 | 9,25 | 8,70 | 8,50 | 8,35 | 1,30 | 1,10 | 0,30 | 0,35 |
| 22-08-07 | 9,00 | 8,60 | 8,50 | 8,35 | 1,30 | 1,10 | 0,30 | 0,35 |
| 23-08-07 | 8,80 | 8,60 | 8,50 | 8,35 | 1,30 | 1,30 | 0,30 | 0,35 |

PLN SPOT PERFORMANCE

| PLN spot performance | | | |
|----------------------|---------|---------|---------|
| date | USD/PLN | EUR/PLN | bias |
| 17-08-07 | 2,8507 | 3,8277 | -22,11% |
| 20-08-07 | 2,8350 | 3,8250 | -22,32% |
| 21-08-07 | 2,8550 | 3,8474 | -21,82% |
| 22-08-07 | 2,8446 | 3,8375 | -22,06% |
| 23-08-07 | 2,8289 | 3,8320 | -22,30% |

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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