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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of December 7th to December 14th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
C/A, EUR	**Dec 12**	**Oct**	**-1.6bn**	-	-0.68 bn	Widening C/A gap stems mainly from the deteriorating balance of transfers with the EU and growing imports.
CPI inflation, y/y	**Dec 13**	**Nov**	**3.5%**	3.5%	3.0%	Inflation rises on the back of higher food prices. Inflation forecast places the growth of prices at the upper band of the central bank's inflation target.

In Focus / Macroeconomics

Inflation in November hit the upper band of the tolerance interval

The Ministry of Finance published on Monday its official inflation forecast for November. The forecast is consistent with our estimates and suggests the inflation rate reached 3.5% y/y hitting thereby the upper end of the central bank's inflation target (2.5% ±1 pp.). We expect a gradual rise of inflation towards the next year.

Much of the growth of inflation stems from rising prices of food and energy and thus does not influence a lot the core measures (we expect that the net inflation rose to 1.5-1.6% in November). At the end of the year, inflation gauge will be lifted mainly by base effects (exceptionally weak monthly growth of food prices in the corresponding month of the previous year) to about 3.8-4.0%. Much depends on the transmission mechanism linking the wholesale markets of unprocessed foods and retail chains. The first symptoms of falling prices in wholesaling have been already spotted, however, owing to the rigidity of prices in retailing, the pass through to retail stores and ultimate consumer seems now to be quite unclear. Rationally expecting, the demand for goods bought for Christmas purposes may be regarded as relatively inelastic, thus keeping the prices high in times of Christmas rush helps to boost the revenue figures.

As for the good news for inflation, this week in Brussels Polish government won a battle for prolonging till 2010 the lower VAT tax rates on some services, books and unprocessed food. Earlier we estimated that the higher VAT tax rates might lift the inflation rate by additional 0.3-0.4 pctg points in January 2008. This notwithstanding, the 2008 inflationary outlook still looks very gloomy; higher gas prices, hikes in regulatory prices, higher prices of processed food including diary products and bakery may lift inflation rate to 4% in the first quarter. The steepening inflation path may generate, or say at least maintain, the market expectations for aggressive interest rate hikes in the first quarter 2008.

MEDIUM-TERM FORECASTS

Indicator	2006	2007	2008
GDP y/y (%)	6.1	6.5	**5.6**
Inflation rate (%)	1.0	2.4	**4.0**
Current account (% of GDP)	-2.1	-4.5	-5.3
Unemployment rate (end-of-year)	14.9	11.5	9.8
NBP repo rate (end-of-year)	4.00	5.00	>6.0

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

Fixed Income

Higher CPI pushed rates up only temporarily

On Monday morning Ministry of Finance gave their CPI forecast for the October. Apparently 3.5% yoy was a bit of a surprise to the market and curve moved sharply some 15-20 bp, especially in the front end (3x6 traded at 6.05 as the high versus 5.83 close of the week). Curve have also flattened to -45 bp between 2 and 10y IRS. We saw some panic closing of positions, and what was also visible was the lack of liquidity. On Wednesday morning after the auction of OK0709 2y benchmark bond sentiment has radically changed. Again very thin liquidity made curve move sharply down from 6.17 to 6.07 in the 2y, virtually on no news. Curve started to steepen and 2y10y spread traded at -38 bp. Also market started to unprice rate hikes again to 5.75 as the ultimate target (from previous 85% chances of 6.00%). We view current events as opportunity to pay, and we prefer 2y sector. we also think that market got to carried away with setting the end of the cycle and actually marking possibility of cuts in 2008 IV Q. However, recently observed poor liquidity, which will probably get worsen as end of year is approaching suggest cautious and limited positioning.

RECOMMENDATION:

Pay short end on dips

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	4.208%	1/16/2006
26 Week T-bills	-	-	3.943%	4/24/2006
52 Week T-bills	12/17/2007	-	5.740%	12/3/2007
2Y T-bond OK0709	1/2/2008	-	5.676%	12/5/2007
5Y T-bond PS0413	2/6/2008	-	5.943%	11/21/2007
10Y T-bond DS1017	2/13/2008	-	5.699%	10/25/2007
20Y T-bond WS0922	1/9/2008	-	5.796%	9/12/2007

Money Market

Nervous and volatile month for liquidity ahead

More rates hikes are coming

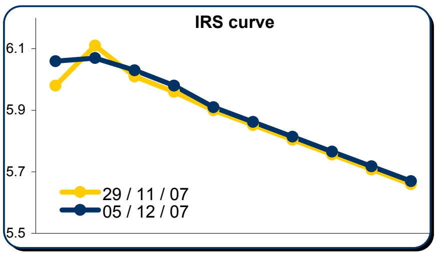
T-bills yields up during the tender

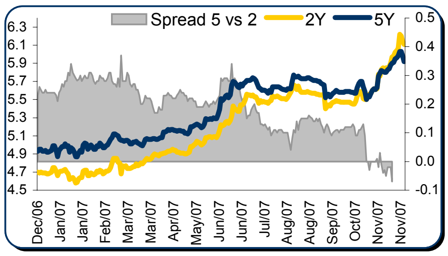
Surprising beginning of the new reserve settlement period. After quite balanced OMO (17 billion pln) shortest rates drooped significantly. The reason was the demand – market bought only 7 billion pln of offered papers. Hence, huge surplus of the cash reaching 10 billion pln. Probably many people had enough of two squeezes in a row plus the PKO SA and BPH merger could be the key. The prisoner dilemma took place and here we go. Next week can be just the opposite. Many can be willing to buy as many money bills as possible, and the carry can go up much above the main market rate. Another scenario says that because of the "end year extra cautious" we will have very cheap whole month, since cash is what everyone will appreciate most.
As for longer terms mixed week. First CPI forecast above the expectations (3.5 vs 3.3%) confirmed further and fast tightening of the monetary policy. Then, sustained VAT rate which was to be increased in January, stronger pln and a very good 2Y bond auction, pushed the rates a spread down. In our opinion it is a good opportunity to take pay positions. We do not believe in rates hike in December, however January and February are good months to hike the rates in a row, plus maybe 50 bps step in February will be necessary.
T-bills yields up during last tender from 5,31% to 5,74%. Because of the highly reduced supply still much behind the curve.

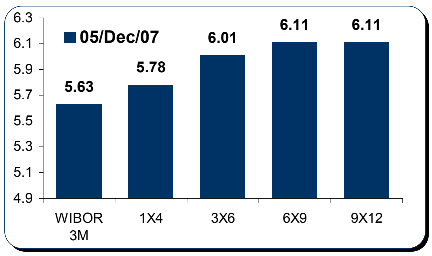
RECOMMENDATION:

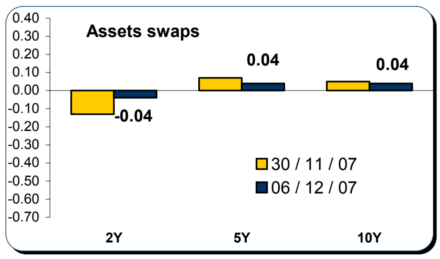
Sell 2M Polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

This week the zloty broke 3,6000 psychological support and options barrier. We think that zloty will stay strong to the end of year with first technical support at 3,5680. Our currency is strongly sported by good macroeconomic indicators and expectations for rate hikes in coming months.

Spot:
Main supports I resistances
EUR/PLN 3,5680 – 3,6300
USD/PLN 2,43700-2,4800

RECOMMENDATION:

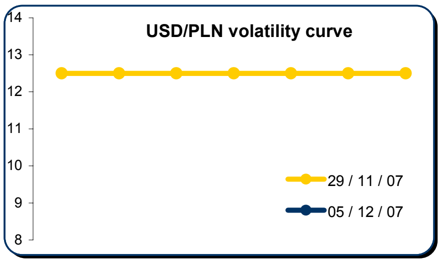
Stay short with target 3,5300

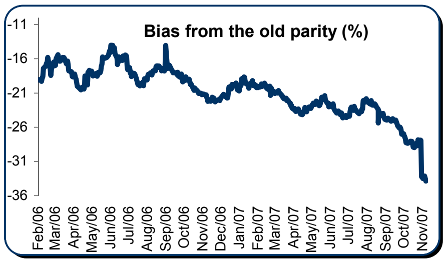
Stay short with target 3,5300 with s/l above the resistance 3,6250

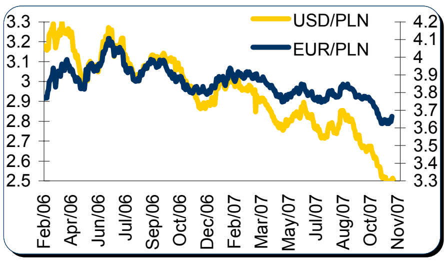
Break of the important barriers at 3.60 and 3.58 in EUR/PLN will support the bid for EUR/PLN volatility. The decent amounts of vega have evaporated from the market makers portfolios. Next barriers are at 3.55 and lower, it’s the field with barriers instead of mines.

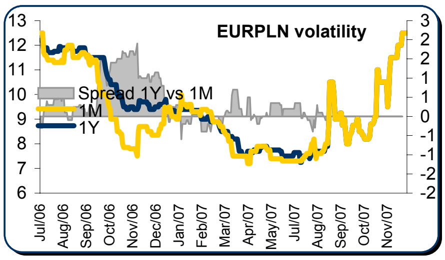
Think the short term gamma up 1month is a good sell as we are still expecting Christmas to come finally. We see the value in buy longer R/R, because of the low spot and historically low risk reversals i.e. 0.45 in 6 month. For ATM’s I would rather tend to sell mid curve if (ideal entry levels of 7 in 3mth and 6.5 in 6 mth).

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
29/11/07	5.50%	5.43%	5.49%	5.64%	5.77%	5.86%
02/12/07	5.50%	5.43%	5.49%	5.64%	5.77%	5.86%
03/12/07	5.50%	5.43%	5.49%	5.64%	5.77%	5.86%
04/12/07	5.50%	5.43%	5.49%	5.64%	5.77%	5.86%
05/12/07	5.50%	5.43%	5.49%	5.64%	5.77%	5.86%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
29/11/07	5.57%	5.78%	5.97%	6.02%	6.04%
02/12/07	5.57%	5.78%	5.97%	6.02%	6.04%
03/12/07	5.57%	5.78%	5.97%	6.02%	6.04%
04/12/07	5.57%	5.78%	5.97%	6.02%	6.04%
05/12/07	5.57%	5.78%	5.97%	6.02%	6.04%

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
29/11/07	5.86%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
02/12/07	5.86%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
03/12/07	5.86%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
04/12/07	5.86%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
05/12/07	5.86%	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	07/12/03	08/12/03	95.415	5.74%	2000	33116	2000
OK0709	07/12/05	09/07/25	90.689	6.17%	2200	7340	2200
PS0413	07/11/21	13/04/25	96.810	5.94%	2200	2611	2200
DS1017	07/10/10	17/10/25	96.607	5.70%	1800	5061	1800

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
29/11/07	11.50	10.15	9.60	9.35	0.60	0.75	0.30	0.35
02/12/07	11.50	10.15	9.60	9.35	0.60	0.75	0.30	0.35
03/12/07	11.50	10.15	9.60	9.35	0.60	0.75	0.30	0.35
04/12/07	11.50	10.15	9.60	9.35	0.60	0.75	0.30	0.35
05/12/07	11.50	10.15	9.60	9.35	0.60	0.75	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
29/11/07	2.4589	3.6267	-34.18%
02/12/07	2.4730	3.6195	-34.13%
03/12/07	2.4675	3.6169	-34.21%
04/12/07	2.4499	3.6075	-34.49%
05/12/07	2.4585	3.5818	-34.71%

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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