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FINANCIAL MARKETS DEPARTMENT

PAGES: 10

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of June 13th to June 19th

Indicator	Date of release	Period	BRE fore-cast	Consen-sus	Last	Comment
CPI Inflation (y/y)	**Jun 13**	May	**4.4%**	4.3%	4.0%	The reading distorted upwards by recent gas and electricity hikes. Also fuel prices exerted upward pressure on the figure whereas food prices resemble usual seasonality. We see net inflation reaching 3.3% y/y.
M3 Supply (y/y)	**Jun 13**	May	**15.0%**	14.9%	14.9%	Unfavorable situation on the stock exchange and resulting withdrawals from mutual funds propel the growth of household deposits; we expect them to have risen by 21.0% y/y in May. At the same time we see a moderate growth of deposits of firms (7.0% y/y).
Employment y/y	**Jun 16**	May	**5.4%**	5.5%	5.6%	Despite softer business conditions, firms are still unwilling to lay off their workers. At the same time, however, they need less new employees than a year ago. A surge in employment rate recorded in January slowly fades out. We expect this tendency to be sustained.
Wages (y/y)	**Jun 16**	May	**10.7%**	11.7%	12.6%	The reading generally consistent with the trend. Last figure was probably distorted by a positive working-days effect. The same mechanism worked towards lower reading last month.

C/A balance (EUR)	**Jun 17**	Apr	**-1.5 bln**	-1.46 bln	-1.6 bln	A spike in industrial output recorded in April and solid appreciation of the zloty generate substantial growth rates of export and imports (both above 30% y/y). Limited scale of EU funds (minimally positive accounting balance) supports C/A deficit at elevated levels (C/A to GDP ratio at 4.2%).
Industrial output (y/y)	**Jun 18**	May	**4.7%**	6.9%	14.9%	Two long weekends last month. It is likely that the story from March will repeat itself and we will see a substantial drop of annual industrial output dynamics. Business indicators trend lower what points to deceleration of industrial output in the months to come as well.
PPI (y/y)	**Jun 18**	May	**2.4%**	2.7%	2.5%	A spike of oil prices (11.0% m/m) offset by lower prices of base metals (in this and the previous month as well) and further EUR/PLN appreciation. Prices of utilities went upwards in May but the exact effect is hard to assess with regard to the aggregate price index.

In Focus / Macroeconomics

This time the macroeconomic section is quite long and split into three parts. In the first one we look at the budget assumptions for 2009; in the second we present our short research concerning inflation whereas the third one sums up the comments of the MPC members and the emerging consensus.

Assumptions for 2009 budget

The Ministry of Finance has recently published assumptions underlying the 2009 budget. The deficit is set to narrow to 18.2 billion PLN (from 18-24 billion forecast by the Ministry for this year) as a consequence of higher revenue base (10% growth compared with 2008) and damped growth of expenditures (6.4% dynamics). As far as the latter is concerned, it is more of a trade off between political will and preserving the so-called social capital, whereas the former issue seems to be simply overly optimistically estimated. The budget debate in Parliament is set to start in September.
The Ministry expects economic growth to reach 5.0% y/y in the coming year (private consumption 5.4% and fixed capital investment 10.0%) with consumer inflation reaching 2.9% y/y. As for the other assumptions, the Ministry sees a substantial growth of wages in the enterprise sector (8.0%), the reference rate at 6.0% and a minor strengthening of the zloty versus the euro to 3.35 on average. All forecasts, with a notable exception of inflation, are close to the consensus view for the coming year.

The above mentioned assumptions may be read as conservative with regard to the projection of revenues. However, it is still the income side of the budget bill where, in our opinion, one can dig for problems. State incomes are set to rise by 10% in the coming year, quite a significant amount taking account of the loss stemming from lower personal tax rates (earlier estimates of the Ministry suggest a dip of nearly 9 billion PLN). What is more, a significant shortage of funds from VAT and excise tax recorded in the first 5 months of this year makes the projected size of those revenues highly uncertain also in 2009.

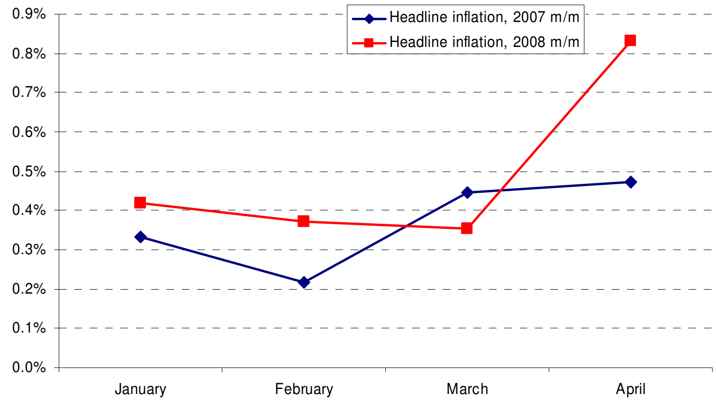
The draft budget bill is consistent with the convergence program issued earlier by the government which, surprisingly, found approval of the EC (the EDP is to be removed in July 8.). The deficit is projected by the Ministry to fall to 1% in 2011 through 2% already planned for 2009. The European Commission is a bit more pessimistic with a deficit at 2.6% in 2009. However, the longer term end of restraining the structural budget gap to 1% seems for them still plausible.

Is Polish inflation really gaining momentum?

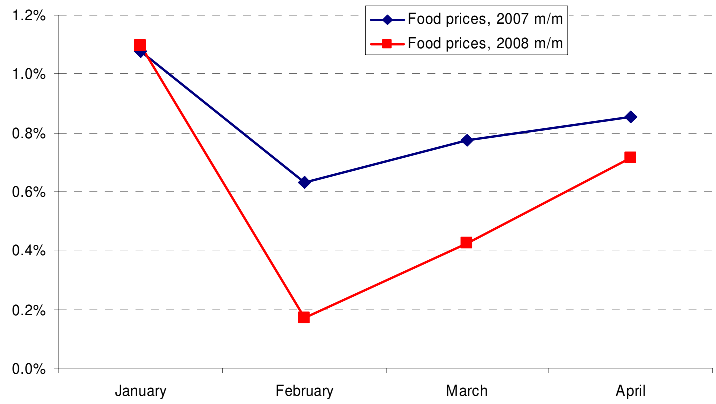
In what follows we present the graphs that may best capture the actual inflation momentum in the Polish economy. Basing on hard data, the net core inflation is very likely to top 4% by the end of 2008 (up from 2.8% recorded in April and 3.3% seen in May). The catastrophic inflation scenario, with core inflation breaching 5% mark, is however hard to square with the facts at the moment.

As annual growth rate of CPI seems not to be a reliable measure of the actual inflation momentum, we rather scrutinize month-on-month changes of price index. In addition, we focus on comparisons of mom CPI dynamics between corresponding months of 2008 and 2007 to escape from the inherent seasonality problems. Such an analysis focuses on the stability of 2008-2007 spreads in mom CPI as a measure of inflation momentum.

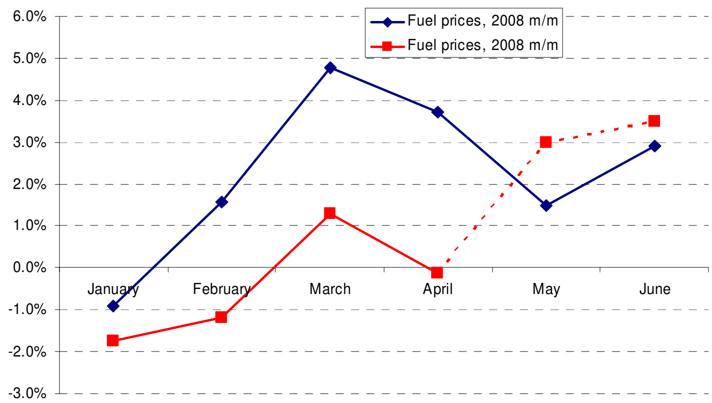
Headline inflation. Over the course of last months, headline inflation has been distorted by many forces, such as energy prices, hikes in state-controlled prices and globalization, often acting in opposite directions. Thus, the spread between mom changes in 2008 and those recorded in 2007 seems not to display any regular pattern. That is also why we rather focus on analyzing various derived inflation indices for food prices, fuel, and “net” core inflation categories.



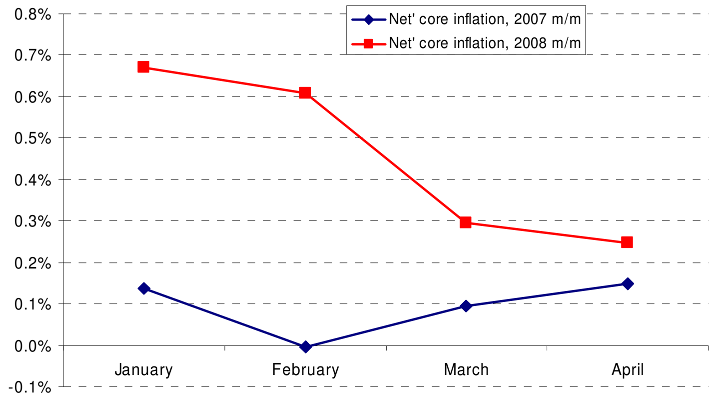
Food prices. First quarters of 2008 brought a slightly lower dynamics, as compared to the corresponding period of 2007, resulting in diminishing contribution of those to the overall inflation measure.



Fuel prices. Strong zloty is to be blamed for pretty low fuel price dynamics in the first quarter of 2008. This is to change in the coming months though. The actual data point to fuel prices surging at a pace of 3-5%, elevating inflation path in the months to come.

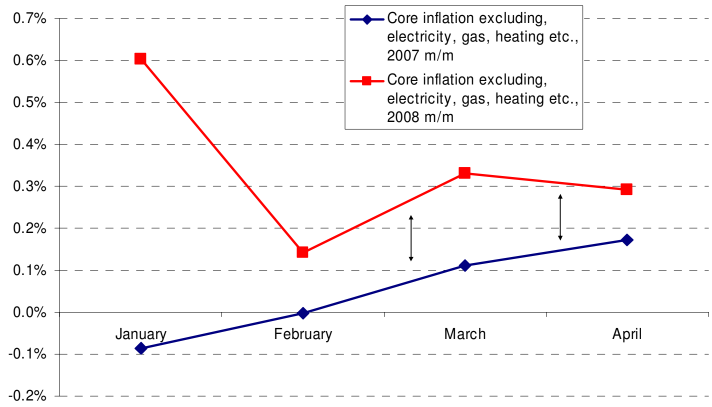


“Net” core inflation. ‘Net’ inflation, the measure of core inflation closely monitored by the Central Bank, was clearly distorted by electricity price hikes implemented in January and February. This inflation measure will be probably additionally skewed by gas and electricity price hikes in May. That is why, we expect the MPC to shift its focus to some 'new' inflation measures capturing all the feedback effects and excluding the direct effects stemming from rising regulated prices.



… So, we examine net core inflation net of electricity, heating etc…

Correcting net core inflation for effects stemming directly form electricity price hikes should allow for assessment of the actual inflation momentum and all the feedback effects. Note that this adjusted measure has shot upwards in January, as many state controlled fees rose as well. This effect has been, however, confined to January only and there is no evidence of rising fees in the consecutive months. Starting in February, the spread between mom CPI dynamics in 2008 and 2007 looks pretty stable ranging from 0.1 to 0.2 pctg points, which translates to above 1 pctg point in annual terms. The aforementioned spread, in our opinion, captures best the feedback effects stemming both from rising labor and production costs as well as those related to the surging demand. If the spread we already defined remains stable in the coming months, net core inflation may rise to about 4% y/y from 2.8% recorded in April. Such an estimate would also be consistent with our baseline scenario of gradually rising inflation pressure and elevated inflation levels in the mid-term.



The catastrophic inflation scenario, with core inflation breaching 5% would be consistent with widening 2008-2007 spreads, which is however hard to square with the facts at the moment.

Monitoring of inflation momentum and the stability of the spread we defined above seem to be crucial for assessing the mid-term inflation perspective and verifying more aggressive scenarios preferred by some market participants at the moment.

The next checkpoints for macro and FI market scenarios are May inflation data release (what is the additional price pressure induced by May gas price hike?) and local (or even global) inflation peak seen in August. In our opinion the Central Bank stuff is very likely to keep supplying the

Polish MPC with analyses resembling ours ahead of both checkpoints.

MPC comments and the slowly emerging consensus

We witnessed a lot of comments from the MPC members in the last few days. The insights into the monetary policy were given by D. Filar, S. Owsiak, J. Czekaj and A. Slawinski. As all the speeches were much the same in conclusions, we decided to comment more fully on Owsiak and Slawiński, a relatively less active members and therefore less thoroughly covered in our publications.

They both point to monetary tightening already in June. Further steps rely much on the inflowing data (and inflation projection) and, last but not least, ECB decision (or even comments given by its members). Slawinski admits - by the way: in line with our earlier research – that business indicators point to softer growth. Linking this fact with elevated inflation makes the decision environment of the MPC very adverse. Professor Owsiak is a bit more optimistic in terms of economic growth and internal demand, however, at the same time he does not regard this scenario as pro-inflationary.

As for the regulated prices – again: we wrote about it several months ago – they may be sufficient to fuel inflation to sustainable 4% level (above the upper level of the tolerance band). Slawinski admits that such a scenario may require the MPC to stick to the restrictive stance for some time. On the other hand, Owsiak sees a chance for easing the monetary policy stance in 2009 – he blunts this view though by citing the uncertainties flowing from the external environment and monetary policy of other banks. As for the latter issue, it is more about the guidance the ECB may offer than a rate disparity raised in several earlier rate-setters' comments.

Making the long story short, recent message conveyed by various MPC members point to an abrupt change of the consensus (2 more hikes this year and a very little chance for easing in 2009). The scenario basing on local factors and a fast return to the inflation target is loosing attractiveness – at least as long as the EBC will maintain its hawkish tone.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008
GDP y/y (%)	6.1	6.5	5.3
Inflation rate (%)	1.0	2.4	4.5
Current account (% of GDP)	-2.1	-4.5	-4.6
Unemployment rate (end-of-year)	14.9	11.4	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

Is the panic over?

Last week didn't change much on the fixed income market. Sentiment remained very weak, bonds sold off, swap curve stayed at highest levels. It seems however, that upside potential for the yields is quite limited. Currently priced in rates scenario, i.e. 2-3 hikes this year and moreover no rate cuts next year is the maximum, of what we can expect, given current macroeconomic situation and most likely future developments. If inflation doesn't surprise on the upside (which seems unlikely), further data releases this month should be rather rate-supportive (lower industrial output and retails sales due to two 4-day weekends). That allows to become slightly positive for the market in the nearest future, especially for the sector up to 2 years.

RECOMMENDATION:

Receive 2 year on tops.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.061%	4/14/2008
26 Week T-bills	-	-	6.220%	4/14/2008
52 Week T-bills	6/16/2008	-	6.774%	6/9/2008
2Y T-bond OK0709	7/2/2008	-	6.193%	4/2/2008
5Y T-bond PS0413	9/3/2008	-	6.155%	5/7/2008
10Y T-bond DS1017	7/9/2008	-	6.054%	4/9/2008
20Y T-bond WS0922	9/12/2008	-	6.080%	5/14/2008

Money Market

T-bills up at last tender

Liquidity was not a problem in the passing week, and it seems that it will stay that way also during the next one. Open market operation was quite moderate with even less demand (8 vs 7.2 billion pln), so we do not see any substantial risk from this side during tomorrow's tender. Benchmark T-bills finally caught up with the MM curves with average yield at 6.74%. In June we have T-bills tender every Monday which is the effect of reduced bond auctions. Hence July can be pretty similar.

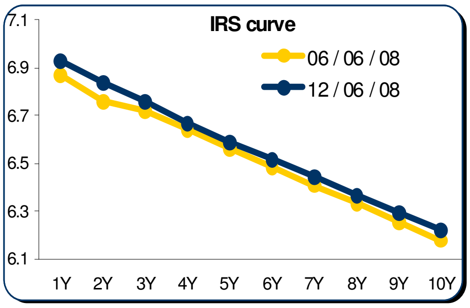
ECB triggered further rates hike expectations in Poland

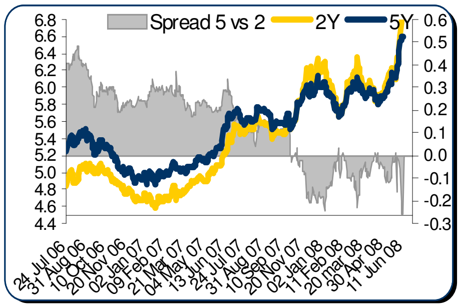
Bearish sentiment lifted all the longer yields up on the basis of some stop loss orders along with some more bearish comments from the MPC side. They became more brave after ECB announced the attempt to the more restrictive monetary policy in the Euroland, which will probably start in July.

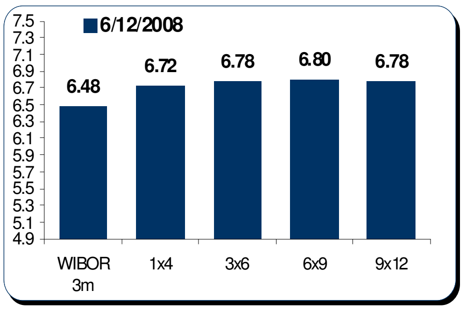
RECOMMENDATION:

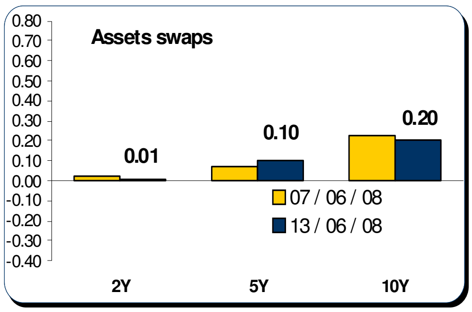
Sell 1y Polonia above 6.5%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker/traded in side trend

Since Friday the zloty was traded between 3.3685 and 3.3400. It is slightly weaker than previous week, though still in range. We observed low pressure for weaker PLN related with uncertainty of interest rates parity in future.

Volatility curve untouched

Because PLN supply became more visible, curve seems to be slightly bided with short end (1M) traded at 6.5 and above and 1Y at 6.1-6.2.

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.3500 / 3.4350
USD/PLN: 2.1300 / 2.2400

Buy on dips

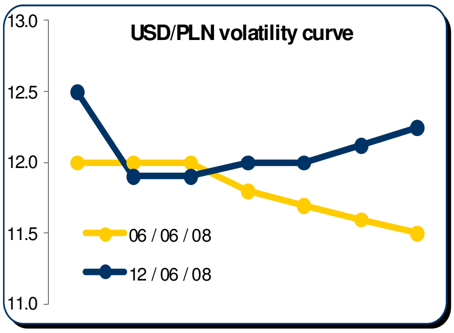
We believe buying at 3.3500-3.3600 zone with S/L at 3.3400 as good idea. Especially if probability of further hikes in U.S. and/or ECB will rise.

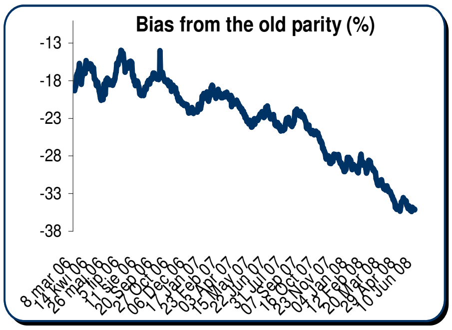
Options:

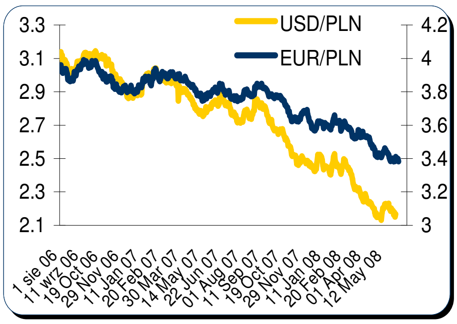
Stay aside/Short EURPLN gamma

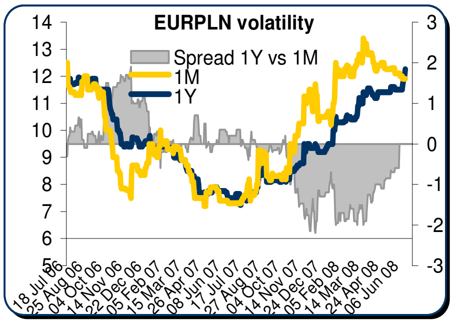
Till PLN sentiment won't clarify we see keeping small amounts of short EURPLN gamma as best idea, but our second-best thought is to buy strikes above 3.4100.

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
06/06/08	6.37%	6.47%	6.67%	6.61%	6.91%	6.68%
09/06/08	6.43%	6.47%	6.59%	6.62%	6.75%	6.70%
10/06/08	6.36%	6.47%	6.67%	6.62%	6.89%	6.71%
11/06/08	6.45%	6.48%	6.62%	6.63%	6.78%	6.73%
12/06/08	6.47%	6.49%	6.62%	6.64%	6.80%	6.73%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
06/06/08	6.71%	6.76%	6.77%	6.76%	6.83%
09/06/08	6.73%	6.77%	6.80%	6.79%	6.86%
10/06/08	6.70%	6.76%	6.80%	6.79%	6.89%
11/06/08	6.71%	6.78%	6.85%	6.84%	6.94%
12/06/08	6.72%	6.78%	6.80%	6.78%	6.85%

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
06/06/08	6.68%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
09/06/08	6.70%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
10/06/08	6.71%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
11/06/08	6.73%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
12/06/08	6.73%	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	08/06/09	09/06/09	93.616	6.74%	1400	2748	1320
OK0710	08/01/02	09/07/25	85.730	6.19%	1800	2047	1654
PS0413	08/04/07	13/04/25	96.211	6.16%	1800	3129	1800
DS1017	08/02/13	17/10/25	96.048	5.79%	2000	2785	2000

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
06/06/08	12.00	11.80	11.70	11.50	0.70	0.85	0.30	0.35
09/06/08	11.90	12.00	11.70	11.70	0.70	0.85	0.30	0.35
10/06/08	11.90	12.00	11.90	11.90	0.70	0.85	0.30	0.35
11/06/08	11.90	12.00	11.90	11.90	0.70	0.85	0.30	0.35
12/06/08	11.90	12.00	12.00	12.25	0.70	0.85	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
06/06/08	2.1675	3.4095	-34.86%
09/06/08	2.1623	3.4044	-34.98%
10/06/08	2.1578	3.4015	-35.07%
11/06/08	2.1610	3.3973	-35.08%
12/06/08	2.1728	3.3823	-35.12%

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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