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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, JULY 4, 2008

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of July 4th to July 10th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
No significant releases						

In Focus / Macroeconomics

Inflation in June running at 4.5% but the perspectives on rates still unclear

The passing week was not abundant with macroeconomic data apart from the MinFin's inflation estimate and the latest compilation of PMI indices. Just as we had expected, the CPI was driven by fuels whereas the real sphere continued pointing downwards. In these circumstances we maintain our view that the MPC will try to identify the strength of the pass-through effects of energy prices in the months ahead. At the same time we underline the risks to economic growth which seem to be underestimated at the moment.

The Ministry of Finance estimated inflation in June at 4.5%, in line with our forecast. Just as we had expected, consumer prices remained under considerable pressure from fuels whereas seasonal drop in the costs of food contributed downwards to the monthly reading of 0.1%. We maintain our previous forecast that the "net" core inflation will top 3.3% y/y, whereas the new core measure introduced lately by the central bank is to stay within narrow interval of 2.1-2.2% y/y. Hence, we expect the pass through effects of higher energy prices and wages to be still limited.

The figure was warmly welcomed by the MPC members (Noga, Wasilewska-Trenkner, Filar) as a meaningful one. However, they once again stressed that the inflation peak is yet to come in August when CPI is likely to exceed 5%. As for the preferred interest rates, the members once again underlined the importance of global factors (oil, food) and the strategy of the ECB.

Almost at the same time, the fresh PMI figures were released. They surprised negatively by reaching 47.2 pts. – the lowest level since March 2005. June was thus the second month in a row which saw a shrinking business activity in manufacturing.

The most important leading indicators for the real sphere (new orders, output and employment) extended losses from the last month, proving that the downside risks to the performance of the real sphere have been recently gaining strength. The most important contribution for the downward slide of the performance was given by the loss of the competitiveness of Polish exports (high exchange rate) amid lower global demand, depressed further by rising costs of materials (fuels, steel and even plastic). The release underpins our relatively low forecast of industrial production in June (8.1% y/y) and employment (5.1% y/y). We do not change our retail sales forecast as it is continuously fuelled by soaring wages.

The perspective on rates seems still unclear. Exogenous shocks experienced by the Polish economy have not triggered yet a strong adjustment towards normalizing relative prices. The enterprises are being put under the heavy pressure from production costs (commodities, wages) but at the same time may experience a slowdown in orders (business indicators shows that this the tendency is growing stronger). It may be then not so easy for them to pass on the rising costs onto consumers in the nearest future. That is why we envisage that the coming months will buy some time for the MPC to assess the scale of the pass-through mechanism. However, at the same time we point to the risks to economic growth which may be underestimated (it is also worth to note that relatively high nominal rates are not supportive for spending activity – either investment or consumption). That leads us to the conclusion that the MPC may rise interest rates in August or September (just before the inflation peak which may have a direct impact on inflation expectations) should the feedback effects in core inflation become visible (according to our calculations, they are still limited though). Postponing the decision till the October inflation projection may be equivalent for a no change in rates at all.

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

What a mess…

Last week we saw quite an impressive rise in yields. Curve has also steepened in the 2y10y area. Market still remain very volatile and very illiquid, we tend to have days when we rarely see any turnover but rates fly 10 bp. each direction. Market in such conditions definitely offers opportunities; problem is that there is no fresh cash in market. Local funds which were main buyer for the past 3 months now face two very unfavorable events. First is positioning, funds chose to go for duration rather than for cash. Choice of having duration had been quite painful, but now is even more painful as clients start to withdraw cash from funds. So now funds have risk and no cash. Internationals on the other hand like paying IRS and receiving WIBOR, they were also main sellers of bonds. The problem with the IRS market is that with recent events on the credit market it has became rather illiquid as limits have shrunk. Our best guess is that the internationals hold upper hand on the market, and it will be their call when to profit on their positions, and it will be done via bonds. We don't think that current market events are macro related, and with current valuations (2y bonds at 7%, 10y bonds yielding 6.75%, asset swaps trading at WIBOR +20) they are not that unattractive as it looks from price action. Weaker part of market was caught and is trapped but once liquidations of these positions starts to unwind we will be closer to end, threat is more dangerous than action itself. Let's wait for this to happen. Till then we recommend cash instruments, while paying rates here can be good reason for scared and illiquid market we still see value in buying short bonds (up to 0710) yielding currently above 7%. Cash will be back to market, end users will not put it all in o/n deposits. We are not completely bearish in this market. Time to put risk on is closing, but not quite yet.

RECOMMENDATION:

Short cash bonds offer value at current levels.

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	7/14/2008	-	6.760%	6/16/2008
2Y T-bond OK0709	8/6/2008	-	6.917%	7/2/2008
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

Cheap end of the reserve

Global sentiment affects our local market

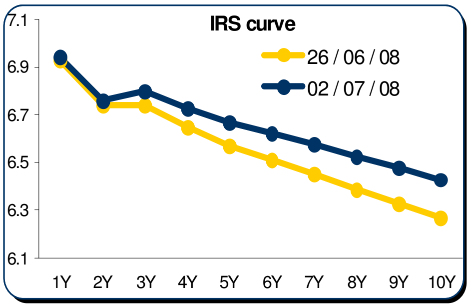
Very cheap end of the reserve despite the open market operation that intended to save the shortest rates. The central bank offered 12.7 billion pln of money bills which would be enough to square the cash market but demand was only 6 billion pln. Cash flooded the market and polonia index dropped by 80 bps plus the whole week was relatively cheap with carry around 15 bps below the main market rate. Tomorrow it is more then certain that open market operation will be huge (15 billion pln?), the question is whether it will be sold out or not. Probably will.

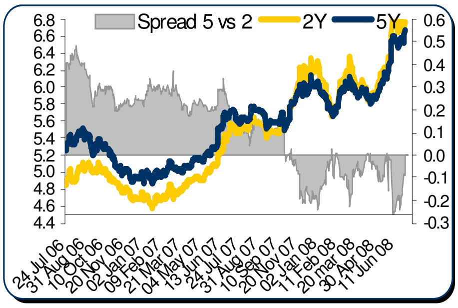
As for longer terms bearish despite of the CPI forecast in line with expectations. MM curves went up 5-15 bps and it seems that global sentiment is now being reflected here. Diving stock exchanges, growing oil prices plus higher CPI in Europe all this drives our local market up in yields. Short term nothing will change.

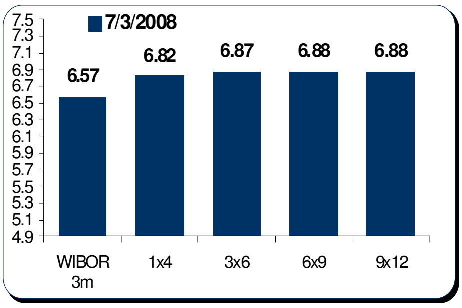
RECOMMENDATION:

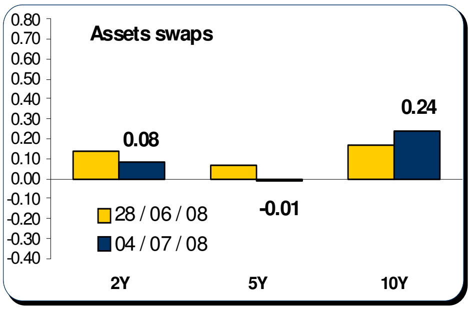
Stay pay.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

Despite the very sour global sentiment (global stock markets, Turkey), złoty is performing really good. It has managed to break two important barrier levels – 3.3500 and 3.3400, which were also important technical support levels.

Volatility curve consolidation

Volatility curve in EUR/PLN is practically unchanged with 1 month at 6.25% and 1year at 6.1 %. There were trades in fly 1 year 25D fly traded 0.4 % and 6 month 25D fly traded 0.3 %.

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.330 / 3.3850
USD/PLN: 2.0900 / 2.1350

Stay aside

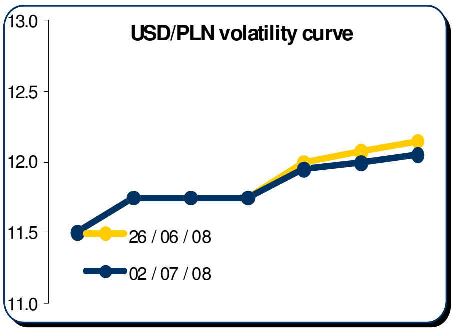
There is the growing discrepancy between the global investment climate and the zloty performance. Despite the increased market risk the barriers are acting as magnesium, taking zloty to the new highs. Next bigger barriers are reported to be at 3.3300 and 3.3000. We recommend to stay aside.

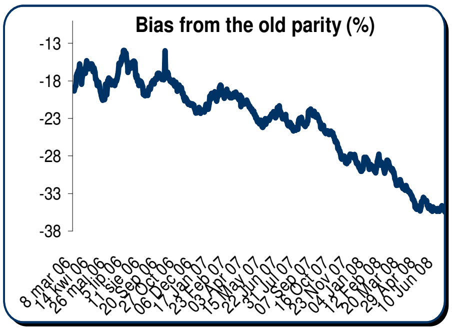
Options:

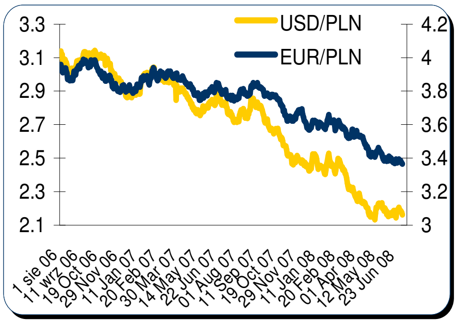
Stay aside/Short EURPLN gamma

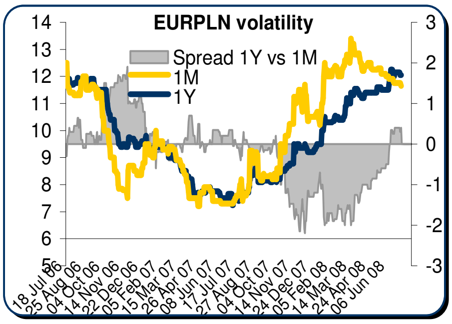
We still are happy to be short gamma in EUR/PLN.

FX CHARTS


USD/PLN volatility curve
13.0
12.5
12.0
11.5
11.0
26 / 06 / 08
02 / 07 / 08


Bias from the old parity (%)
-13
-18
-23
-28
-33
-38


USD/PLN
EUR/PLN
3.3
3.1
2.9
2.7
2.5
2.3
2.1
4.2
4
3.8
3.6
3.4
3.2
3


EURPLN volatility
Spread 1Y vs 1M
1M
1Y
14
13
12
11
10
9
8
7
6
5
3
2
1
0
-1
-2
-3

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
26/06/08	6.35%	6.36%	6.62%	6.49%	6.83%	6.59%
27/06/08	6.37%	6.54%	6.66%	6.70%	6.86%	6.80%
30/06/08	6.35%	6.55%	6.65%	6.71%	6.84%	6.81%
01/07/08	6.56%	6.56%	6.71%	6.71%	6.81%	6.81%
02/07/08	6.57%	6.57%	6.72%	6.71%	6.82%	6.81%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
26/06/08	6.76%	6.74%	6.76%	6.72%	6.79%
27/06/08	6.77%	6.79%	6.82%	6.77%	6.87%
30/06/08	6.76%	6.81%	6.83%	6.80%	6.90%
01/07/08	6.76%	6.83%	6.84%	6.82%	6.90%
02/07/08	6.76%	6.85%	6.88%	6.87%	6.93%

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
26/06/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
27/06/08	6.80%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
30/06/08	6.81%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
01/07/08	6.81%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
02/07/08	6.81%	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	08/04/02	10/07/25	87.000	6.19%	2700	4925	2700
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
26/06/08	11.75	11.75	12.00	12.15	0.70	0.85	0.30	0.35
27/06/08	11.75	11.75	12.00	12.15	0.70	0.85	0.30	0.35
30/06/08	11.75	11.75	12.00	12.15	0.70	0.85	0.30	0.35
01/07/08	11.75	11.75	12.00	12.15	0.70	0.85	0.30	0.35
02/07/08	11.75	11.75	11.95	12.05	0.70	0.85	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
26/06/08	2.2035	3.3915	-34.66%
27/06/08	2.1941	3.3870	-34.82%
30/06/08	2.1835	3.3852	-34.96%
01/07/08	2.1805	3.3765	-35.10%
02/07/08	2.1731	3.3685	-35.28%

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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