POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of July 18th to July 24th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Industrial output	**Jul 18**	Jun	**8.1%**	10.2%	2.3%	One working-day more on m/m and y/y basis. Lower number of inflowing orders (m/m and y/y). A gradually declining trend of business tendency indicators (softer new orders backed by PMI and the first assessments regarding reduction of the number of employees).
PPI	**Jul 18**	Jun	**2.9%**	2.9%	2.7%	Another surge of oil prices in PLN (7% m/m) accompanied by lower prices of base metals (including substantial reduction of the costs of lead). A moderate increase of price expectations.
Net inflation	**Jul 22**	Jun	**3.3%**	3.3%	3.2%	Feedback effects from higher energy and food still limited. We expect the new measure of core inflation (excluding energy and food) at 2.2% y/y.

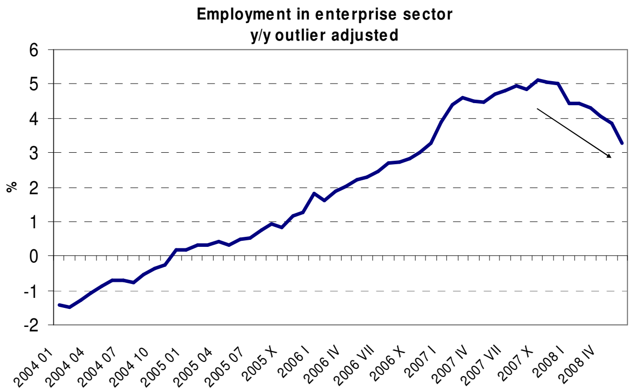
In Focus / Macroeconomics

It is more and more about a looming slowdown…

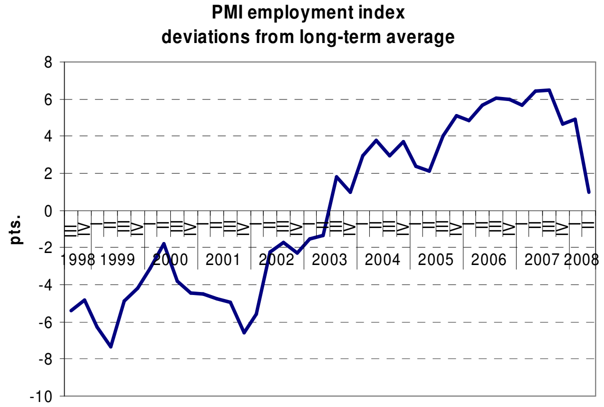
It has been some time since we started to glean clues about a looming slowdown from every data we observe. The story started with business tendency indicators (mainly new orders indices) and since then it has finally mirrored itself in the employment data.

The aforementioned indicators may prove to be of higher relevance as the volatile data on industrial output and retail sales reflect more structural struggles within an economy. It is rather a widely shared view that enterprises detest labor force turnover, hence: it requires a substantial deterioration of financial standing, as measured by profits (either current or anticipated), to lay off the staff.

Recent data on employment showed a substantial deterioration of its growth rate – from nearly 6% recorded at the beginning of the year it dipped to 4.8%. The comparison on monthly basis looks more alarming: employment stagnated for the two consecutive months, quite unusual phenomenon for this time of the year. The effect can be quite easily spotted while we plot annual variation of employment growth rates after adjusting for outliers (occurring at the start of each year and linked to switch of database upon which the statistical office performs its calculations).



The conclusions drawn from the real data are being to large extent confirmed by PMI employment components. After they peaked in mid-2007, there are moving closer to long-term average and the correction is quite abrupt.



The peak of the business cycle has already passed. At the moment, the GDP growth is being fuelled increasingly by domestic consumption, supported by substantial growth rate of wages – factors specific to the "just-after-peak" phase of the business cycle. The direction we see now is clearly downwards. Outright declines in employment (to become visible in coming months) are going to limit the bargaining power of employees and ultimately distort consumer confidence. Softer demand and depressed profits are leading to lower investment activity, driving the GDP growth towards 4% or less in the coming year.

…But nominal sphere still of highest relevance for the monetary outlook this summer

Slightly higher than expected CPI inflation figure for June accompanied by very hawkish, but isolated, comments of MPC member Filar triggered an abrupt reaction of the financial markets - the best proof for the relevance of the upcoming data from the nominal sphere.

Going into details, CPI inflation rose in June by 4.6% y/y (market consensus 4.5%). As for the culprits of the rise there are food prices that posted a decline of 0.6% m/m - a bit short of usual seasonal pattern of summer drops. The prices of goods relevant to monetary policy reached 3.3-3.4% as measured by the net core measure ("old" core inflation) and 2.1-2.2% as reflected in the "new" core inflation (calculated excluding the prices of food and energy). This backs our view that feedback effects from higher energy prices are still relatively well contained. However, June's reading may still be significant in terms of alleged second round effects, especially when wages continue to soar at 12.0% y/y (market consensus 11.2%). This trend is very unlikely to reverse soon as employees may at least partly back their assessment of the economic situation on the already outdated data (see sticky information hypothesis).

That is why we continue to expect that the rate hike expectations may be still fueled by a gradual rise of CPI inflation (to be observed in the coming months) and by the inflation peak of 5% y/y expected to occur in August. We advise, however, to be cautious with bearish sentiment - it is still of utmost importance to closely monitor the real sphere (see the piece on employment above) and potentially very dovish comments of the MPC (some of the MPC members have already ruled out any tightening by the release date of the new inflation report in October). Turning to the timing issue, we expect economic growth worries to dominate the outlook late this summer, by then abrupt shifts in rate hike expectations (partly being induced by the behavior of foreign central banks) are to characterize the outlook for the Polish economy.

MEDIUM-TERM FORECASTS

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

Continuation of expected "unexpected" rally

Last week was still continuation of the bullish trend. Bonds and IRS touched new low levels some 10 bp in yield lower than we have expected. We also saw some fresh money (mainly from pension funds - OFE and banks) flying into bond market. We still are rather neutral at this level, especially after hard data putting some question marks on the economy. Volatility is still very high and liquidity is getting even poorer. Figures that are ahead of us can prove to be of great importance if production comes below consensus. Market looks it wants to be bullish and perhaps is right but our feeling is that it is more based rather on hope and belief than fundamental picture we still see. We tend to agree with current trend for lower yields but to confirm that we would need to see a bit more than new lows on the PLN. And it certainly doesn't look like buyers of zloty buy bonds, it looks that they maybe be here but only for a short while. This week we don't give any recommendation. But if production goes strongly below consensus we will be buying bonds in front end of the curve.

RECOMMENDATION: Buy bonds in front end of the curve should production goes badly

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	8/11/2008	-	6.850%	7/14/2008
2Y T-bond OK0709	8/10/2008	-	6.500%	7/9/2008
5Y T-bond PS0413	9/3/2008	-	6.155%	5/7/2008
10Y T-bond DS1017	10/8/2008	-	6.054%	4/9/2008
20Y T-bond WS0922	9/12/2008	-	6.080%	5/14/2008

Money Market

Carry stable but getting squeezed

Quite a substantial open market operation (18 billion pln) plus demand overwhelming the supply, supported cost of carry. However, the system is lacking around 3 billion pln as far as reserve requirements are concerned. Hence, either tomorrow' open market operation will be much smaller or the squeeze will be more painful.

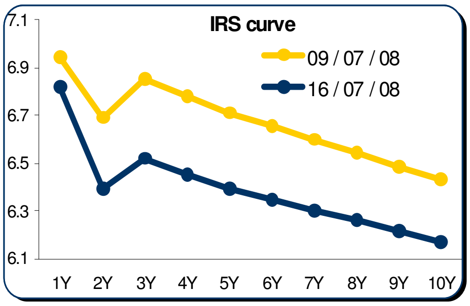
Figures bearish market bullish

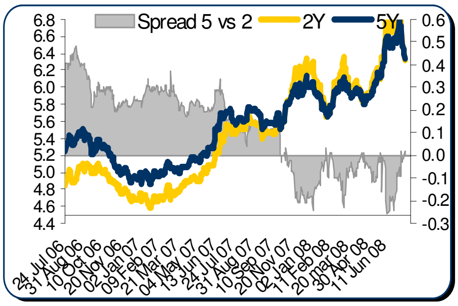
For longer terms bullish. No matter what it is bullish. It started when polish currency hit new lowest levels against usd and euro, but then we had some new information that should off set it. Wages 12%, CPI 4.6% both higher then expected. Then USA CPI 5% and better then expected IO. Logic says bearish. The inflation problem is spreading faster and further. Market says bullish. It is hard to argue with the market but we bet on logic. Now OIS curve does not discount even one full rate hike, for us it is just bar-gain to do some shopping.

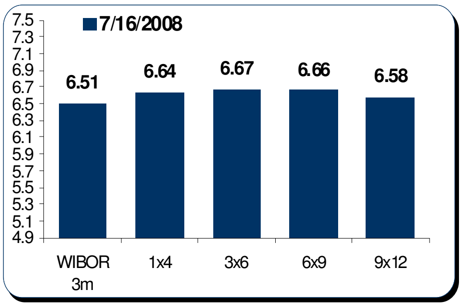
RECOMMENDATION:

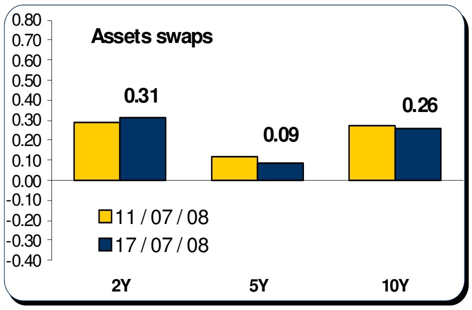
Pay on dips.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

This week PLN was traded between 3.2650 and 3.2088. Good global sentiment with even better regional one, made PLN best performer of CE4 reaching new low.

Volatility curve higher

Volatility curve is traded higher with 1M at 6.6 and 1y at 6.35. Quickly strengthening of PLN and barriers triggered with this move still provide demand for PLN vega/gamma.

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.2000 / 3.3000
USD/PLN: 2.0000 / 2.1200

Stay aside

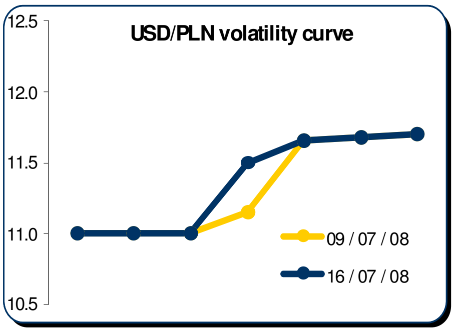
Breaking down (!) EURPLN downward trend at 3.2250 makes us looking for further gains, although rising likelihood of correction keeps us on 'stay aside' recommendation.

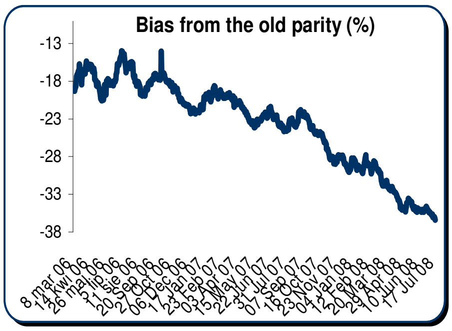
Sell vega on upticks

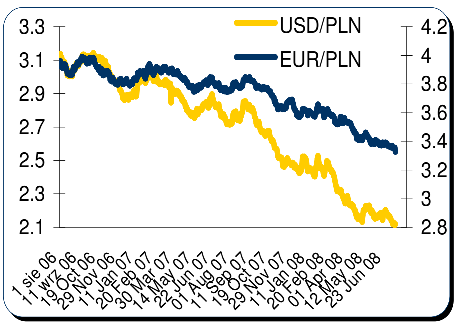
Options:

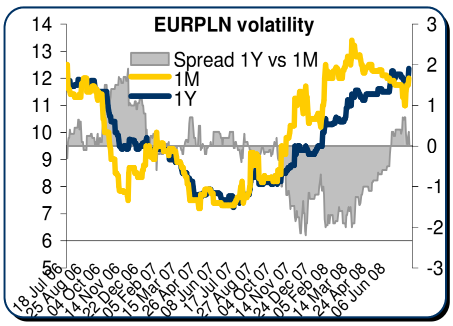
We see this maintaining demand as opportunity to open short vega positions.

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
10/07/08	6.53%	6.55%	6.67%	6.68%	6.78%	6.79%
11/07/08	6.54%	6.54%	6.68%	6.68%	6.79%	6.79%
14/07/08	6.53%	6.56%	6.67%	6.69%	6.80%	6.79%
15/07/08	6.27%	6.51%	6.46%	6.66%	6.70%	6.79%
16/07/08	6.29%	6.50%	6.48%	6.65%	6.72%	6.79%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
10/07/08	6.69%	6.70%	6.70%	6.65%	6.77%
11/07/08	6.68%	6.71%	6.69%	6.60%	6.70%
14/07/08	6.67%	6.71%	6.68%	6.61%	6.69%
15/07/08	6.68%	6.80%	6.79%	6.73%	6.81%
16/07/08	6.64%	6.67%	6.66%	6.58%	6.67%

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
10/07/08	6.79%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
11/07/08	6.79%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
14/07/08	6.79%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
15/07/08	6.79%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
16/07/08	6.79%	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	08/07/14	09/07/14	93.596	6.77%	1200	3253	1298
OK0710	08/07/02	10/07/25	87.143	6.92%	1000	2250	1000
PS0413	08/04/07	13/04/25	96.211	6.16%	1800	3129	1800
DS1017	08/07/09	17/10/25	91.480	6.50%	700	2461	705

FX VOLATILITY

date	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
	1M	3M	6M	1Y	1M	1Y	1M	1Y
10/07/08	11.00	11.50	11.65	11.70	0.70	0.85	0.30	0.35
11/07/08	11.50	11.75	11.80	11.80	0.70	0.85	0.30	0.35
14/07/08	11.75	11.75	11.80	11.80	0.70	0.85	0.30	0.35
15/07/08	11.75	11.75	11.80	11.80	0.50	0.75	0.30	0.35
16/07/08	11.75	12.00	12.00	12.00	0.50	0.75	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
10/07/08	2.1366	3.3694	-35.69%
11/07/08	2.1194	3.3542	-36.06%
14/07/08	2.1293	3.3543	-35.95%
15/07/08	2.1222	3.3558	-36.01%
16/07/08	2.1140	3.3559	-36.11%

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

Contact Details

BRE BANK SA

Ul. Senatorska 18
00-950 Warszawa
P.O. Box 728
Poland

Reuters Pages: BREX, BREY, and BRET

Bloomberg: BRE

SWIFT: BREXPLPW

www.brebank.pl

Forex (BREX) - FX Spot &Options

Marcin Turkiewicz (+48 22 829 01 84) Marcin.turkiewicz@brebank.pl
Jakub Wiraszka (+48 22 829 01 73)
Tomasz Chmielarski (+48 22 829 01 78)

Fixed Income (BREP) - FRA, IRS, T-Bonds, T-Bills

Łukasz Barwicki (+48 22 829 01 93) Lukasz.barwicki@brebank.pl
Paweł Białczyński (+48 22 829 01 86)

MM (BREP) - MM, FX Swaps

Bartłomiej Małocha (+48 22 829 01 77) Bartlomiej.malocha@brebank.pl
Tomasz Wołosz (+48 22 829 01 74)

Structured Products (BREX)

Jaroslaw Stolarczyk (+48 22 829 01 67) Jaroslaw.stolarczyk@brebank.pl
Jacek Derezinski (+48 22 829 01 69)

Institutional Sales (BRES)

Inga Gaszkowska-Gębska (+48 22 829 12 05)

Research

Ernest Pytlarczyk (+48 22 829 01 66) Research@brebank.pl
Marcin Mazurek (+48 22 829 0183)
Radosław Cholewiński (+48 22 829 12 07)

Financial Markets Department
Phone (+48 22 829 02 03)
Fax (+48 22 829 02 45)

Treasury Department
Phone (+48 22 829 02 02)
Fax (+48 22 829 02 01)

Financial Institutions Department
Phone (+48 22 829 01 20)
Fax (+48 22 829 01 21)

Back Office
Phone (+48 22 829 04 02)
Fax (+48 22 829 04 03)

Custody Services
Phone (+48 22 829 13 50)
Fax

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