



POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

**IN FOCUS /
MACROECONOMICS**

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- ...but the rate setters' comments remained mixed

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PREVIEW: The week of July 25th to July 31st

Indicator	Date of release	Period	BRE fore-cast	Consensus	Last	Comment
Retail sales	Jul 25	Jun	17.0%	16.0%	14.9%	One working day more m/m and y/y. Softer business indicators on monthly and annual basis. No long weekends this month but a slight base effect concerning Corpus Christi (this year in May). Home appliances sales (mostly TV sets) probably distorted upwards by EURO2008.
MPC Decision	Jul 30	-	6.0%	6.0%	6.0%	Moods in the MPC still indecisive, the dominance of wait-and-see stance. Rising inflation pressures may made the MPC hike in August/September before the slowdown in GDP growth will become a fact.

In Focus / Macroeconomics

All six core inflation measures went up in June...

All six core inflation measures reported for the Polish economy increased in June. Going into details, net core inflation excluding food and fuels rose to 3.4% from 3.2% recorded in Mai. The new measure excluding food and all energy was up by 0.1 pctg. point from the previous reading of 2.1% y/y. Core inflation calculated as 15% truncated mean, the measure perceived by many statisticians as the most reliable, topped 4.9% in June.

We expect the core inflation to rise in the coming months on the back of higher labor costs. One cannot rule out some feedback effects stemming from higher energy and food prices to materialize as well. Consequently, we estimate the net core inflation to top 4% and the new core measure excluding energy and food to breach 3% mark by the end of this year. It has to be noted though that both measures will be significantly affected by the low base effect stemming from the lower internet fees in August 2007. As inflation path may get steeper in the coming months, one may expect more hawkish comments from the central bank officials.

Turning to the cross-regional comparisons, we see more and more pronounced divergence in terms of inflation trends in the CEE countries. While inflation rates in Hungary and Czech Republic are clearly heading south, dampening rate hike expectations, Polish inflation is to accelerate in the coming months. Having in mind the market's reasoning behind the latest rally (weakening economic growth and presumed lower inflationary pressures in the region), upcoming inflation data may induce a corrective move across the yield curve.

As for the negative inflation scenario, the important event to watch was the parliamentary debate on inflation. Such a political motivated debate and catastrophic inflation projection echoed by the press pose a clear threat to inflation expectations. That is why we uphold our view that these developments accompanied by higher inflation readings may stimulate rate hike expectations and consecutively force the MPC to hike.

...but the rate setters' comments remained mixed

Recent data releases cemented the split among the MPC members, visible in their recent comments. However, traditional division into hawks and doves does not describe the situation well as moods in the MPC have to be canvassed also in shades of gray. The mosaic of thoughts raises the importance of single macroeconomic data; we still see a possibility of a hike in August/September.

The most hawkish stance was presented by Filar. He attaches the greatest importance to core inflation measure pointing out that its current level is too high. Should core inflation stay around 2%, the return to the target will be easy, otherwise – it may be hard and prolonged. Filar also pointed out the significance of communication between the MPC and market participants (financial entities and households), especially the one regarding inflation expectations, closely connected to the occurrence possibility of the second round effects. Relatively hawkish was also the stance of Wasilewska-Trenkner. In her opinion strong currency cannot serve as a substitute for interest rate hikes as the former can be easily reversed in monetary policy horizon.

The comments from Noga, Czekaj and Slawinski may count as relatively grey in comparison with the ones delivered by other members. Noga and Czekaj belong to the "October-camp" which conditions the decision on rates on the next inflation projection. They both advise observing closely the economy in order to find confirmation on softening growth, persistence of the dynamics of wages and the slide of inflation just after the peak. Slawinski pays much attention to the exchange rate of the zloty, describing the effects of its current strength on inflation and growth. Appreciating currency always back the restrictiveness of monetary policy, but when it goes too far (beyond equilibrium exchange rate) it may pose problems for exports. In his opinion, the zloty is decisive for the monetary policy at the moment.

The other extreme is occupied by Nieckarz. In his opinion, strong zloty hampers exports which may drag down the GDP growth below 4%. At the same time, potent currency reduces inflationary pressures what makes Nieckarz think that current discussions on restricting monetary policy further are pointless.

**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

Boring...

Even though volatility on the market seems to quite decent it's hard to say there is anything really interesting going on. As payers and receivers interchangeably get advantage over the others, yields fluctuate within 10bp range, but there is definitely no clear trend. And it doesn't seem like one is about to crystallise in the nearest future and we can see some range trading before new data will give some answers about economic situation. We're slightly more inclined towards pay position, however in current environment of relatively high volatility and low liquidity it seems to be the best idea to take advantage of all overreactions in both directions. Levels below 6.60% on 2Y seems as cheap to pay, 6.85% on the other hand as a receiving opportunity.

RECOMMENDATION:

Play range.

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

Cheap end of the reserve very likely

Smaller demand during open market operation tender (12,7 vs 14 billion pln) provided nice and cheap carry for the whole week. Since we are heading to the end of the reserve requirements settlement period (next Wednesday), we will probably see cheap short deposits for a few more days.

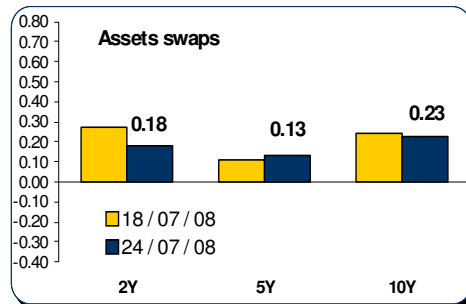
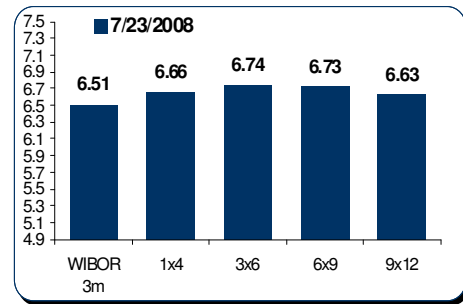
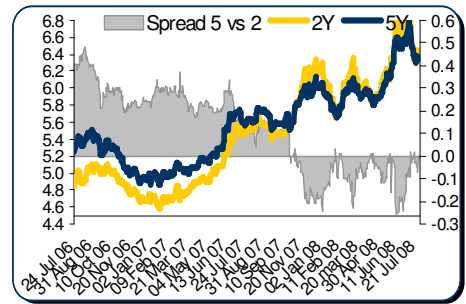
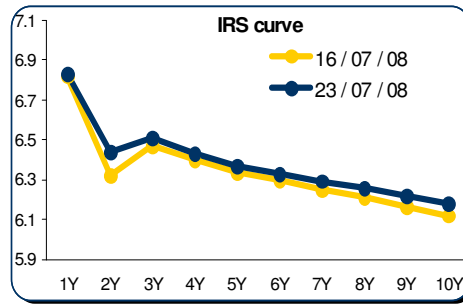
Core CPI a bit higher then expected

A little better PPI and a little worse IO figures had very limited impact on longer rates. However a little higher core CPI proved that inflationary pressure is still high which in turn and along with the very fast growing wages will, in our opinion, force the MPC to hike the rates further. This will become fact sooner or later but is not discounted in the curve (less then one full hike is priced in now). We still consider it as a great opportunity to pay some more.

RECOMMENDATION:

Pay on dips.

FIXED INCOME & MONEY MARKET CHARTS



Foreign Exchange

Zloty stronger

This week PLN was traded between 3.2028 and 3.2686. The correction of EUR/PLN broke the downward movement lasting since June 27. During last six days zloty increased by almost 7 figures. USD/PLN rebound as well and reached yesterday the level of 2.0784. This rally was triggered by profit taking in C4 currencies and possible interest rate increase in the Czech Republic. Today zloty came back to its long-term trend.

Volatility curve higher

Volatility curve was traded higher with 1M at 7.25 and 1Y at 6.5 as compared to 6.4 and 6.2 respectively in the previous week.

RECOMMENDATION:

Spot:
Main supports / resistances:
EUR/PLN: 3.2000 / 3.2700
USD/PLN: 2.0150 / 2.0800

Buy PLN

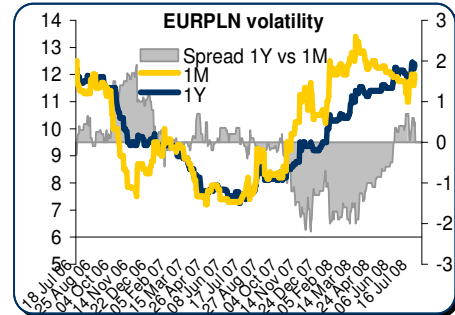
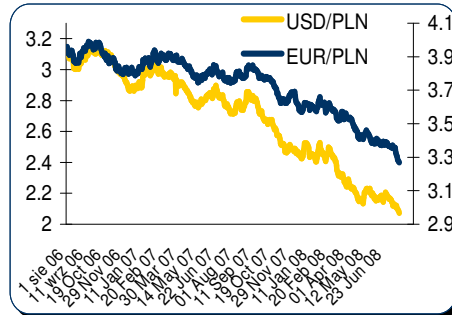
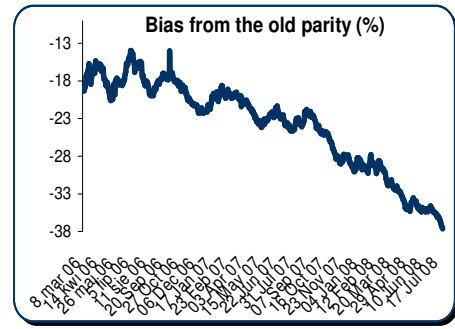
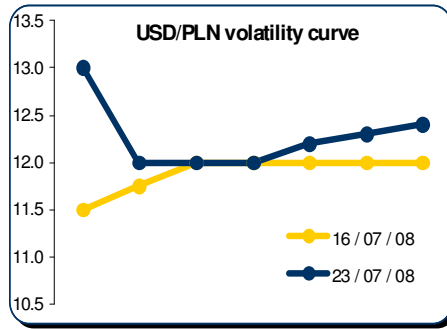
The current move created the occasion to buy PLN at the levels of 3.3550-3.3650 placing stops at 3.3950, take profits at 3.2000.

Options:

Sell vega

There was the opportunity to open short vega positions by selling 3M at 7,0%, 9M at 6.55% and 1Y at 6.50% . We also prefer to keep short gamma positions, as we don't believe that current turmoil will persist.

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
17/07/08	6.51%	6.51%	6.64%	6.63%	6.79%	6.78%
18/07/08	6.50%	6.51%	6.63%	6.63%	6.78%	6.78%
21/07/08	6.51%	6.51%	6.62%	6.62%	6.77%	6.77%
22/07/08	6.50%	6.51%	6.61%	6.61%	6.76%	6.76%
23/07/08	6.19%	6.51%	6.58%	6.60%	6.75%	6.75%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)					
date	1X4	3X6	6X9	9X12	6X12
17/07/08	6.64%	6.69%	6.69%	6.57%	6.68%
18/07/08	6.66%	6.71%	6.70%	6.59%	6.69%
21/07/08	6.67%	6.72%	6.71%	6.61%	6.71%
22/07/08	6.69%	6.74%	6.73%	6.63%	6.73%
23/07/08	6.66%	6.74%	6.73%	6.63%	6.73%

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
17/07/08	6.78%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
18/07/08	6.78%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
21/07/08	6.77%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
22/07/08	6.76%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
23/07/08	6.75%	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
17/07/08	12.00	12.00	12.15	12.35	0.50	0.75	0.30	0.35
18/07/08	11.85	12.05	12.25	12.45	0.70	0.95	0.30	0.35
21/07/08	11.75	11.95	12.15	12.35	0.60	0.85	0.30	0.35
22/07/08	11.60	11.80	12.00	12.20	0.45	0.70	0.30	0.35
23/07/08	12.00	12.00	12.20	12.40	0.75	0.75	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance			
date	USD/PLN	EUR/PLN	bias
17/07/08	2.1199	3.3273	-36.38%
18/07/08	2.1193	3.3155	-36.52%
21/07/08	2.1015	3.3052	-36.85%
22/07/08	2.0956	3.2841	-37.17%
23/07/08	2.0843	3.2736	-37.42%

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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