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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of August 29th to September 4th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
GDP	**Aug 29**	Q2	**5.4%**	5.6%	6.1%	GDP growth fuelled by private consumption and fixed capital formation (inflated probably by outperforming construction). Negative contribution of net export of 0.8-0.9 pp. scale.

In Focus / Macroeconomics

MPC on hold: restrictive bias remains but risks of economic slowdown clearly admitted

Polish MPC left rates unchanged at 6.0%, meeting market expectations. The statement issued after the meeting suggests the monetary policy remains restrictive (the sentence “MPC does not exclude that bringing inflation to the target may require further monetary tightening” was left intact). However, there are some passages bearing a more dovish flavor. First of all, the MPC commented economic growth seemingly more broadly; an “uncertainty concerning economic growth” was replaced with “uncertainty concerning the scale of economic slowdown”. MPC also acknowledged lower prices of oil. Among factors that may limit inflationary and wage pressures there were deteriorating financial standing of companies and the strength of the zloty (a passage on appreciation exceeding the equilibrium pace disappeared though).

During the Q&A session the MPC representatives agreed that the zloty should be seen as a neutral factor for the monetary policy. The comments that followed confirmed also that the Committee is increasingly worried about the deteriorating growth prospects. Well known hawk Filar declared even that it was the slowing economy behind the decision of not hiking the rates. In his opinion, in terms of monetary policy, Poland may not follow the direction set by other central banks in the region, as the rate policy is to be conducted to account for individual features of the economies. This view has not been shared by his college J. Czekaj who expects the Committee to closely monitor the developments in Czech Republic and Hungary as well as in the euro zone.

Going to the inflation forecasts Filar indicated that the core inflation would climb to 2.8%, up from the latest reading of 2.2%. This jump is attributed to the arithmetic low base effect, indeed the core inflation is set to rise by meager 0.1% on a monthly basis in August. Czekaj, in turn, sees the headline inflation to moderate to 4.2-4.4% by the end of 2008 and the economy to slow to 4-4.5% in 2009. He still does not expect the rates to be cut this year but sees the chances for such a move in 2009.

The market reacted more abruptly to the comments made by Noga (the yields rose by 10 bps). Noga sees inflation to edge up to 4.9% in December 2008. He also envisages an upward correction to the next inflation projection to be released late October. Noga expects the economic growth not to slow visibly and the economy to growth at a sound 5% next year. Not surprisingly, he still expects the rates to be raised this year.

Note that our forecacts clearly differ from those announced by M. Noga. Arithmetic high base effects and lower oil prices will bring the headline inflation downwards in Autumn. As for the official inflation projection, accounting for a slowdown in the EU and lower oil prices may lower the central projection path as well. We see the falling inflation and deteriorating growth outlook (we expect the industrial output to fall on the annual basis in August) to determine the market expectations regarding the rate path. In short, we do not expect the Committee to hike the rates this year. Finally, the cyclical slowdown (we view Polish economy to be much more correlated with its European counterparts during this cycle and thus we regard the consensus view of Polish economy growing at 5% as exaggerated) to result in monetary easing (75-100 bps) in 2009.

Retail sales continue to grow, tomorrow’s Q2 GDP release purely historical given the ongoing changes in economic environment

Retail sales growth amounted in July to 14.3% y/y after 14.2% recorded a month earlier. The figure was largely in-line with consensus, so was the breakdown. The aggregate was dragged down by auto sales which recorded an annual drop of 5.6%, consistent with sharply descending trend. Growth rates of other categories remained almost unchanged from the last month. Retail sales deflator reached 4.2% after 4.1% in the previous month. The core deflator (excluding food and fuels), however, proved to be weaker this month totaling 0.4% y/y versus 0.7% a month ago.

As usual we extracted some other, more interesting aggregates. Retail sales excluding fuels and food sales amounted to 18.2% y/y (after 18.5% a month earlier) vs. average 21.3% in the first half of the year, proving the private consumption is loosing steam very slowly. We shall then look for the roots of the coming slowdown clearly not there.

In our opinion, it is the supply side where the economic slowdown is coming from (the statistical office announced recently that factory orders recorded in July an annual drop - readings from earlier months posted substantial gains; it constitutes further confirmation of the trend pointed by business indicators). Private consumption is the last aggregate to fade during the business cycle. It is the supply side weakness what will be sufficient for the MPC to refrain form hiking and initiate discussion on lower rates.

The aforementioned supply side weakness is not going to be particularly visible in Q2 GDP data, to be published on Friday, which conveys purely historical information. We expect GDP to reach 5.4% y/y after 6.1% in Q1. As for the breakdown, we expect significant growth rate of consumption (about 5.5% y/y) and still decent dynamics of fixed capital formation (inflated to some extent by outperforming construction sector) at a level of 16.5% y/y. Taking into consideration the widening foreign trade gap, we estimate the net exports to mark a significant negative contribution of 0.8-0.9 pp though.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.1	4.0
Inflation rate (%, avegage)	1.0	2.4	4.5	3.7
Current account (% of GDP, average)	-2.1	-4.5	-4.6	-5.3
Unemployment rate (end-of-year)	14.9	11.4	9.8	9.6
NBP repo rate (end-of-year)	4.00	5.00	6.00	5.25

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.4	4.7	4.0	3.8	3.8
Inflation rate (%, average)	4.3	4.7	4.0	3.9	3.7
NBP repo rate (end-of-quarter)	6.00	6.00	6.00	6.00	5.75

Bold denotes chages from the last release with arrows showing the direction of chages

Fixed Income

What we see an others do not

The biggest event of the last week was RPP meeting. While the decision was in line with market expectations and comment was rather unchanged apart from little parts the biggest impact had some comments on the conference. Suggestion that growth may be stronger than expected and that next projection may show higher CPI path made the damage to the market. We strongly disagree. We see economy slowing down rather significantly, we think that this month figure will show that IP will print below zero on the year on year basis, we think that CPI will decline 0.3 month to month, PPI will show also negative dynamics, same with retail sales. Lets add to that what is happening in Eurozone and add some lag to our economy, the picture for the coming quarter can be really give very negative surprise as far as growths and quite positive surprise as far as inflation. Rates in 9x12 at around 6.10 for us show great value on the down side, we like receiving 9x12 with target level of 5.50. And that would only mean RPP stays on hold this year and cuts in April 2009 25 bp, which is our base scenario.

RECOMMENDATION: Receive 9x12 with target level of 5.50

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	9/8/2008	-	6.490%	8/18/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
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

Relatively high cost of carry despite the fact that at least theoretically we had surplus on the reserve account. Seems like people are building the reserve, which in turn increases probability of cheap end of the settlement period (tomorrow).

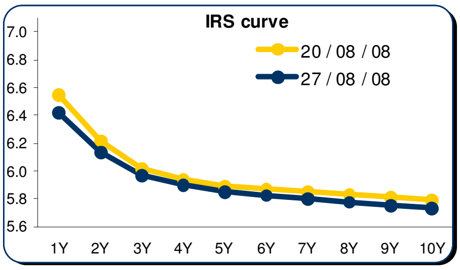
Comments after the MPC decision perceived as hawkish

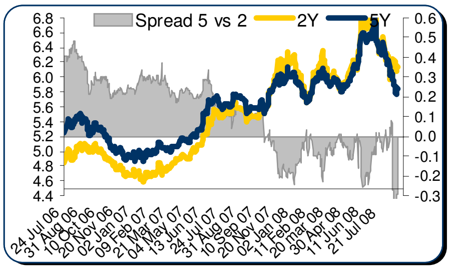
Still bullish for longer terms, however The MPC comments after the decision (no change), along with quite low levels started slight correction movement. The point is that the comments were almost identical with those made last month. It is just changed environment (no hikes plus two cuts discounted in the curve) that gave completely different perspective. Lots of volatility till September figures ahead.

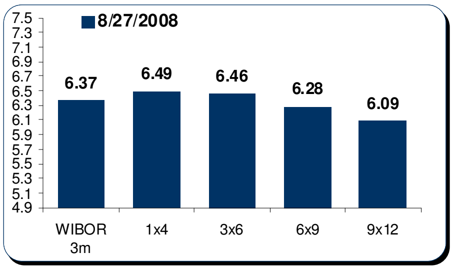
RECOMMENDATION:

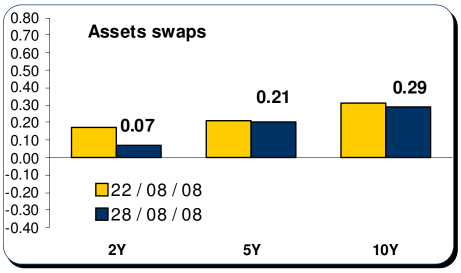
Buy 3M polonia, sell 1Y.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty stronger

After slight hiccup in previous week, the zloty has continued to weaken to main currencies. EUR/PLN moved up from 3.2900 to 3.3550 bouncing back 50 pips above our previously set resistance. USD/PLN has also travelled upward form 2.2070 and changed its direction slightly before 2.2850 level. On Wednesday MPC left the base rate unchanged at 6.00% in line with expectations.

Volatility curve unchanged

This week EUR/PLN and USD/PLN volatilities oscillated narrowly near 7.00/6.60 (1M/1Y) and 12.70/12.45 respectively.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 3.2800 / 3.3600
USD/PLN: 2.1900 / 2.3000

Neutral PLN

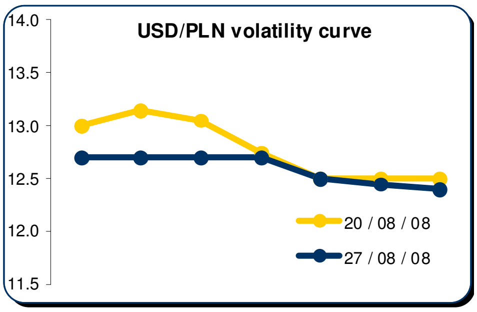
Recently zloty is lacking momentum, therefore we suggest waiting for the break through above mentioned support/resistance levels to decide upon further action.

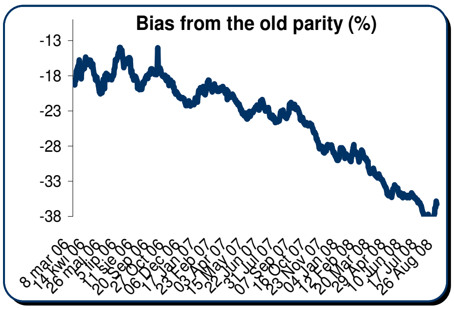
Hold short vega and gamma

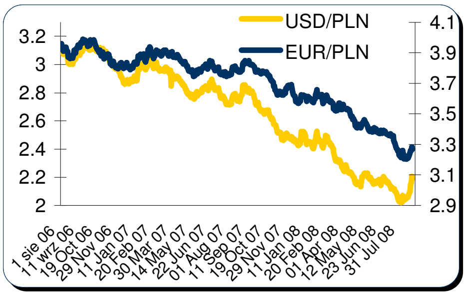
OPTIONS

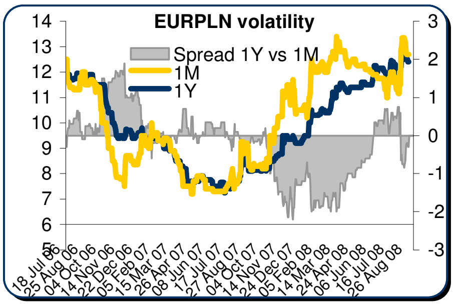
Keep short vega and gamma anticipating probable volatility curve mean-reverting.

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
21/08/08	6.35%	6.36%	6.45%	6.49%	6.26%	6.59%
22/08/08	6.38%	6.39%	6.53%	6.48%	6.61%	6.55%
25/08/08	6.38%	6.37%	6.45%	6.46%	6.53%	6.53%
26/08/08	6.36%	6.37%	6.44%	6.47%	6.52%	6.52%
27/08/08	6.39%	6.39%	6.41%	6.48%	6.35%	6.53%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
21/08/08	6.47%	6.36%	6.23%	6.03%	6.17%
22/08/08	6.48%	6.37%	6.25%	6.03%	6.22%
25/08/08	6.45%	6.37%	6.25%	6.03%	6.19%
26/08/08	6.45%	6.34%	6.17%	5.95%	6.11%
27/08/08	6.49%	6.46%	6.28%	6.09%	6.23%

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
21/08/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
22/08/08	6.55%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
25/08/08	6.53%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
26/08/08	6.52%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
27/08/08	6.53%	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	08/08/18	08/08/18	93.842	6.49%	500	2330	500
OK0710	08/08/06	10/07/25	88.390	6.47%	1800	3724	1830
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

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
21/08/08	12.75	12.75	12.50	12.50	1.00	1.00	0.30	0.35
22/08/08	12.70	12.70	12.50	12.50	1.00	1.00	0.30	0.35
25/08/08	12.70	12.70	12.50	12.50	1.00	1.00	0.30	0.35
26/08/08	12.70	12.70	12.50	12.40	1.00	1.00	0.30	0.35
27/08/08	12.70	12.70	12.50	12.40	1.00	1.00	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
21/08/08	2.0975	3.2460	-37.60%
22/08/08	2.1495	3.2600	-36.84%
25/08/08	2.1620	3.2590	-36.71%
26/08/08	2.2078	3.2835	-35.89%
27/08/08	2.1915	3.2690	-36.25%

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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