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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 18th to September 26th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Core inflation y/y	**22 Sep**	Aug	**4.0%**	3.8%	3.5%	The monthly variation of core inflation still limited. Strong annual readings spurred by base effects. We expect the new core measure (excluding prices of food and energy) at 2.7-2.8%.
MPC decision	**24 Sep**	-	**6.0%**	6.0%	6.0%	We attach the risk of a hike of 30-40%. We cannot rule it out completely as some MPC members still see a hike as the one making the recently announced euro adoption more credible. Disinflation pressures becoming visible in the horizon.
Retail sales y/y	**26 Sep**	Aug	**11.5%**	12.2%	14.3%	Business tendency indicators at the last month's level. 2 working days less in annual terms; one day with sales officially banned.

In Focus / Macroeconomics

August data softer than expected

Much lower inflation

In August CPI inflation amounted to -0.4% m/m and 4.8% y/y, which was far below the market consensus and MinFin's estimate (both 5.0% y/y). That means the annual CPI figure for August, which was expected to set a peak, in fact did not exceed the July reading (4.8% y/y). This "surprise" was due to a significant fall of food and fuel prices (by 1.6% m/m and 1.9% y/y respectively), which counterbalanced strong base effects from the previous year. However, the latter are still visible in core inflation measures. We estimate the net inflation (excl. food and fuels) for August at 4.0% y/y (+0.5 pp. from July) and the new core inflation measure (excl. food and energy) at 2.7-2.8% y/y (+0.5-0.6 pp. from July). Nevertheless, in m/m terms core inflation measures rose only moderately, by 0.2% and 0.1% respectively. That is in line with our view that the secondary effects of rising food and energy prices have been so far limited.

With food and energy prices trending downwards, September should see the CPI inflation falling to 4.4-4.6% y/y, partially due to base effects.

With food and energy prices trending downwards, September should see the CPI inflation falling to 4.4-4.6% y/y, partially due to base effects. Because of the latter, by the end of the year the headline inflation rate may decline further below 4.0% y/y. However, that does not refer to the core inflation readings, which in the coming months will still indicate a higher momentum.

Lower employment and wages

Employment in enterprise sector stagnated for the fourth month in a row reaching in August 4.2% in annual terms (after 4.7% recorded in July). The reading is consistent with business sentiment indicators which stubbornly point to the ongoing job losses. The section which sheds the majority of jobs is manufacturing, not accidentally also the one suffering most from the global slowdown. Other sections are unlikely to follow suit (less dependence on exports) but also unlikely to lag behind for long. We seek for outright declines in employment (in monthly terms) in coming months.

We seek for outright declines in employment (in monthly terms) in coming months and restrained wage growth.

Softer employment was accompanied by substantially lower wage growth which posted 9.7% y/y after 11.6% in July. The dynamics is vividly softer than in recent months and - what is most important - unlikely to be distorted by extra payments. The ongoing changes in economic environment (including global slowdown and effects of the credit crunch on the one hand and problems of local enterprises on the other) are sufficient to restrain the wage growth around current levels, especially when the projected slowdown of the Polish economy may prove more severe.

Industrial output turns negative, producer prices in downward trend

Industrial output surprised market consensus on the downside by dropping by 3.7% y/y (last reading equal + 5.9% y/y). Such an abrupt shrinking of the production stream owes some to the negative difference of working days, but also hinges on the ongoing slump of economic fundamentals, visible in business tendency indicators for quite long (softer global demand and still visible cost pressures, this time really harder to pass on to consumer due to deficiencies in demand). We do not expect this situation to resolve fast; positive surprises may be only spurred by the positive difference of working days - track seasonal adjusted data then to see the ongoing weakness to spill over.

Positive surprises to IO only on working days; seasonally adjusted trend clearly pointing downwards

Producer prices in August surprised slightly on the downside reaching 2.0% y/y (market consensus at 2.1% y/y). Last month's data were revised substantially downwards by 20 bp. to 2.1%, and here lies the main culprit of positive monthly variation of producer prices in all sections. Price expectations of enterprises are showing clearly that prices quoted by firms should be trending down (watch strong upward base effects in October-December period). Such a scenario is backed by relatively low levels of oil prices and base metals.

The data proved to have only very limited impact on the FI market due to liquidity problems. It applies to inflation which failed to break a long expected 5.0% threshold and to industrial output, which finally turned negative. Although we see the risk (30-40%) of another rate hike (in September), such a move could not be seen as justified by fundamentals (we see some signs of disinflation including clear symptoms of economic slowdown). The only reasons why one cannot rule out such a possibility are the comments of MPC members indicating that a rate hike could increase the monetary policy credibility ahead of the ERM2 entry (we doubt such an explanation though and elaborate on this field and other policy dilemmas more thoroughly in the piece below concerning the euro adoption). This notwithstanding, we see the rate cuts to be delivered as soon as in 2008 Q1/Q2.

Poland set to adopt the euro – a follow up

This week, after a joint meeting of government and central bank officials, the official goal of the euro zone accession has been reiterated. In a brief statement PM Tusk reassured that both the government and central bank will act towards the fulfilling the Maastricht convergence criteria by 2011. The legal and procedural issues, including an agreement on central parity exchange rate (expected Q1 2009) and the assessment of the convergence process by EU (2 years from the ERM-2 entry, mid 2011) make it more realistic that Poland will ultimately adopt the common currency in 2012. This notwithstanding, the joint statement of the government and central bank is propelling the convergence game at the long end of the yield curve but adding to the policy dilemmas at the short end.

Restrictive stance may render the euro adoption plan more likely, however, the restrictiveness of the policy is a relative measure and depends itself on the phase of the business cycle.

The more reliable and less distant the euro adoption plan is, the more restrictive monetary policy should be – at least in the light of the words uttered by the most hawkish members of the MPC (Wojtyna, Filar, Wasilewska-Trenkner, Sławiński and even Czekaj). Restraining stance may then render the euro adoption plan more likely, however, the restrictiveness of the policy is a relative measure and depends itself on the phase of the business cycle.

We see then the Polish monetary policy to closely follow the movements taken by the ECB in the medium-term, the most likely scenario at the moment. Such a stance may be also helpful in limiting the volatility of the exchange rate. As for the nearest MPC decisions, recent comments of the MPC members eschew current macroeconomic data (keeping expectations at the inflation peak in reins) and put forward another interest rate hike. In these circumstances, the comments of Czekaj may be regarded as the relatively most modest ones. He does change the balance of risk towards lower inflation but, at the same time, fails to exclude any upward rate movements at all – it is inflation projection to decide.

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 (%)	5.8	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

Swan song of the hawks

It has been quite interesting week. Long expected inflation peak over 5% never happened and it doesn't look that it will ever happen. Industrial output fell by 3.7% y/y, PPI were also slightly lower than consensus. Yearly wages dynamics are also slowing. It's very surprising however, that in such circumstances we've heard so many hawkish comments from MPC members, reiterating necessity of further tightening in quite significant scale. The picture is becoming clearer and clearer - the economy is slowing, inflationary pressures are fading and these trends will only escalate in the future. Of course it will take some time for the wages for example to go to levels satisfactory for the rate setters, but being forward looking means ignoring current data and seeing what is happening and what will happen soon. Rate hikes now would only mean significant currency strengthening - imagine 200bp or more of spread in rates over Euro just 3 years before adoption of the common currency. We're more and more confident that tightening cycle has ended and it's only matter of time when Council doves will become the majority.

Position wise we've closed our convergence spread. 5y5y forward below 20bp over Euro has no value any more. We remain receive in 9x12 and in 2y-5y sector. We also start to like bonds again in this sector - at current ASW levels they seem more and more attractive.

RECOMMENDATION:

Close 5y5y. Stay receive 2y and 5y.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.061%	7/28/2008
26 Week T-bills	-	-	6.409%	9/15/2008
52 Week T-bills	10/13/2008	-	6.426%	9/15/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
5Y T-bond PS0413	10/1/2008	-	6.114%	9/3/2008
10Y T-bond DS1017	10/8/2008	-	6.054%	4/9/2008
20Y T-bond WS0429	9/12/2008	-	5.992%	9/10/2008

Money Market

Expensive due to USD turmoil

Bullish figures against fast joining the monetary union

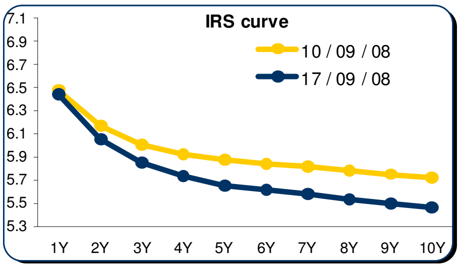
Squeeze on liquidity despite of the surplus of the cash in the system. All we can figure out is that further after-effects of the global credit crunch made local players to be over-cautious. There is high probability that demand during tomorrow's OMO will be very low and we will get back to normal. Also probability of cheap short cash is growing despite of the fact that official Wibor rates will stay high.

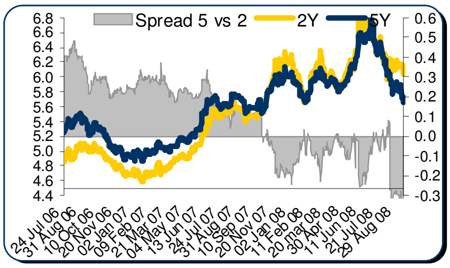
Market is highly confused. Bullish figures (CPI 4.8% against expected peak above or at 5%, wages below 10%) confronted with the announcement of joining monetary union in 2011, and MPC comments that it would require further monetary policy tightening. Range trading, waiting for next figures and the MPC meeting next week. Market lacks the liquidity due to shrinking credit lines, less counterparties, all it makes volatility to be unpredictable.

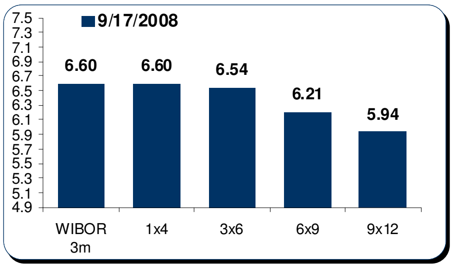
RECOMMENDATION:

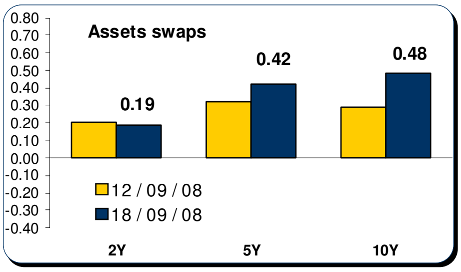
Pay 1y polonia nearby 5.9%.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty really volatile

If last week was a rollercoaster, we have no expression for this one.

This week Zloty was really volatile, moving from band to band, between 3.315 and 3.3857 on EUR/PLN (with a single shoot on Tuesday at 3.4257) and on USD/PLN between 2.3222 and 2.3599. With government agreement with the Central Bank (on EUR adoption on 2011), and Lehman Story plus the global equity performance being the main drivers.

Volatility extreme high

There were no runs on EUR/PLN or USD/PLN and only single trades showed healthy demand for gamma. The volatility curves have jumped to the extreme levels, not only because of high historic volatility but also because of “Lehman position unwinds” and the growing concern about derivatives lines being “on watch” with use to be main markets players from US. EUR/PLN 1M was traded at 11.25 while week before we had seen 9.80 and 1Y moved to 7.6 from 7.40. For USD/PLN respectively 1M volatility was at 17.00 and 1Y at 14.75.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 3.3000 / 3.3.4500
USD/PLN: 2.3500 / 2.4250

Neutral PLN

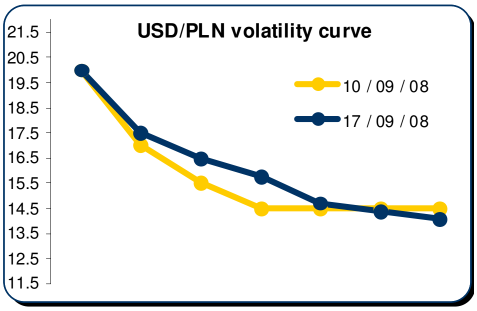
One can find reasons to be short or long zloty but whatever you do, remember the liquidity Is really poor and the markets tends to open with huge gaps. We still think playing the wider range 3.30 -3.4500 is a good idea. But smaller positions and wider stop losses are advisable…

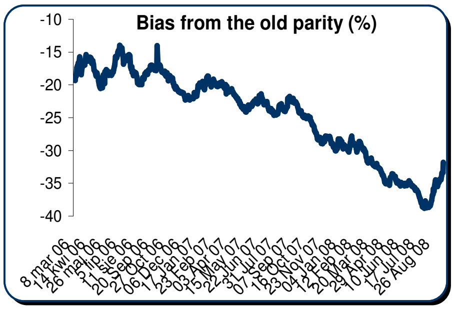
OPTIONS

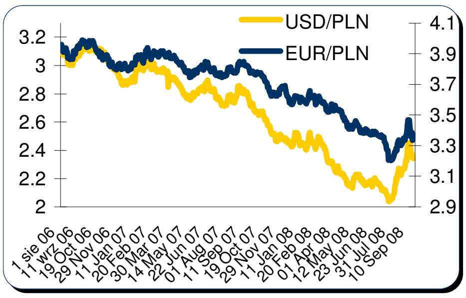
Hold short vega

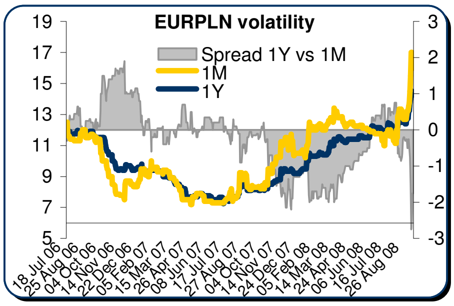
We have no other recipe for pain, as we already short vega. The current jump in volatility Was not only driven by the increased historic volatility, but also (mostly?) due to Lehman positions which have evaporated from the books and the credit lines between banks being cut . We think this is abnormal situation which should not last long, and in that we trust.

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
11/09/08	6.42%	6.53%	6.47%	6.49%	6.52%	6.59%
12/09/08	6.47%	6.54%	6.55%	6.51%	6.39%	6.52%
15/09/08	6.40%	6.59%	6.47%	6.54%	6.28%	6.55%
16/09/08	6.49%	6.60%	6.54%	6.54%	6.56%	6.55%
17/09/08	6.52%	6.62%	6.53%	6.55%	6.27%	6.56%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
11/09/08	6.59%	6.59%	6.23%	6.01%	6.16%
12/09/08	6.59%	6.58%	6.26%	6.02%	6.20%
15/09/08	6.54%	6.46%	6.14%	5.89%	6.07%
16/09/08	6.54%	6.45%	6.08%	5.81%	5.99%
17/09/08	6.60%	6.54%	6.21%	5.94%	6.11%

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
11/09/08	6.59%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
12/09/08	6.52%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
15/09/08	6.55%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
16/09/08	6.55%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
17/09/08	6.56%	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	08/09/16	09/09/16	93.899	6.43%	800	1994	800
OK0710	08/08/06	10/07/25	88.390	6.47%	1800	3724	1830
PS0413	08/09/03	13/04/25	96.459	6.11%	2200	8986	2200
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
11/09/08	16.00	14.25	14.25	14.25	1.80	1.60	0.30	0.35
12/09/08	16.00	14.25	14.25	14.25	1.50	1.40	0.30	0.35
15/09/08	17.00	15.75	14.70	14.10	1.80	1.60	0.30	0.35
16/09/08	17.00	15.75	14.70	14.10	1.80	1.60	0.30	0.35
17/09/08	17.50	15.75	14.70	14.10	1.80	1.60	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
11/09/08	2.4505	3.4106	-34.45%
12/09/08	2.3793	3.3595	-34.46%
15/09/08	2.3591	3.3618	-33.84%
16/09/08	2.3763	3.3861	-33.44%
17/09/08	2.3472	3.3363	-33.40%

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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