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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of September 26th to October 2nd

Indicator	Date of release	Period	BRE forecast	Consen-sus	Last	Comment
MinFin's Inflation Forecast	**Oct 1**	Sep	**4.4%**		4.8%	Annual indicator affected by high base effect (surging food prices in Fall 2007). Moderate rises on m/m basis of food prices, fall registered in fuels. Core "net" inflation set to rise towards 4.1%, new core measure to 2.8% y/y

In Focus / Macroeconomics

Polish rates on hold. We see the tightening cycle to be over.

In line with analysts' expectations Polish MPC kept all rates unchanged on its September meeting. Turning to the statement, the Committee clearly changed its assessment of the state of the economy. Now it sees the looming slowdown to be more severe implying GDP to grow below its potential pace (the risks has been most recently confirmed by the drop of retail sales growth). Although the Committee acknowledges the possibility of further tightening, the reader should not interpret the passage in a manner similar to the ECB's beloved 'strong vigilance' phrase. The aforementioned passage has been introduced couple of months ago and it probably only refers to elevated levels of current inflation without any direct implications for the actual monetary policy perspectives. As the Committee dropped the passage referring to negative effects the supply shocks (higher food and energy prices) may have on the disinflation path, one may rather expect the MPC to get more comfortable with the inflation outlook – we pointed to the changes on global commodity markets and the turnaround in headline inflation in the vast majority of economies several weeks ago as a potential drivers of polish inflation as well.

To conclude, the statement of the MPC seems to be supporting the dovish side. It is as dovish as it may be given the elevated levels of current inflation and the ongoing fight for the credibility of the MPC itself. We see the tightening cycle to be already over and do not buy the arguments of those expecting the MPC to hike the rates in October. Actually, it was September, when the Committee might have justified the hike as a move towards meeting the Maastricht convergence criteria. We are also questioning the main reason behind the rate hike in October (which is apparently postulated by the majority of economists), i.e. the new inflation projection. Lower than assumed food and oil prices, slowing EU economy and much stronger zloty as well are, based on the official central bank's model, working towards much lower inflation path in 2009. As for the expected more restrictive monetary policy on the EMU accession path, we expect the MPC to realize soon that due to the ongoing zloty appreciation (one should relate this phenomenon directly to the EMU accession) the monetary policy (in terms of the MCI) has been already tightened.

Polish Debt Management Strategy 2009-2011

The government has recently approved the Debt Management Strategy of the Public Sector for 2009-2011. The borrowing needs of the state are set to gradually decline towards 2011, owing much to the reduction of budget deficit (it is planned to reach 1% of GDP in 2011 in structural terms); general government debt to GDP ratio is going to reach 42.1% in 2011. Revamped debt management aims at limiting refinancing, interest rate and exchange rate risk considerably, however, the underlying assumptions of the strategy together with attached sensitivity analysis encourage to take on a more skeptical view (at least on borrowing needs and its cost).

As for the refinancing risks, the treasury plans to increase debt ATM above 5 years (minimum plan) with ultimate level for domestic debt and total debt in 2011 amounting to 6.4% and 6.7% respectively from contemporary levels of about 4.33 and 5.23 accordingly. Average duration connected with interest rate risk is set to rise towards 4.1% in 2011 from about 3.51 in 2008. As for the exchange rate risks, the strategy aims at reducing the volume of foreign issuing: the ratio of domestic and total debt is planned to be reduced to 42.1% (from 43.5% noted in mid 2008). Making the long story short, the Debt Management Strategy is heading towards longer-term financing which enhances its flexibility. Furthermore, lower dependence of foreign financing is forecast to reduce exchange rate risks and, implicitly, the costs of hedging. Last, but not least, the treasury takes the fast EMU entry for granted and thereby tries to exploit the benefits of longer term financing, affected by the already started convergence game.

As for the assumptions, the most striking are the estimated GDP growth rates. The Ministry of Finance sees the ongoing slowdown to be rather a shallow one (those who think we are growth pessimists are kindly advised to watch market consensus which slowly drifts to our view, presented some months ago). Growth rate in 2008 is expected to reach 5.5% and stay close the 5% line in 2009 and 2010 amounting to 4.8% and 4.9% respectively. We would rather advise to scale the figures (especially those for 2009 and 2010) down by about 0.8-1 pp. According to the sensitivity analysis attached to the Debt Management Strategy it may imply the rise in borrowing needs of about 4 bln PLN and 8 bln PLN in 2009 and 2010 respectively. Although it would do no harm to the convergence criteria, the downward pressure on prices of existing debt may be visible.

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	**4.4** ↓	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

It is all about inflation and growth momentum

Last week main event was (should be) MPC meeting. Although in our opinion the most important piece was retail sales data which showed significant downward diversion from market expectations. The set of data last month was very clear. All data showed lower growth and lower CPI pressure. Even famous core CPI on the month to month basis showed marginal increase of 0.09% which translates into 1% annualized. We agree that ERM entry can complicate life of the MPC and the market. We agree there are dilemmas about how hard it will be to fulfill the CPI criteria. But facts are facts. Growth momentum has peaked, CPI have peaked, rates have peaked. Maybe MPC will have to be more restrictive than without ERM2 entry, maybe CPI target will have to be changed to 2%, but it certainly doesn't mean higher rates in nominal terms. MPC will have to look more closely to what ECB is going to do, and it is very hard to expect ECB to hike rates. It is very hard to expect Polish MPC to hike rates. It is all about economy after all.

RECOMMENDATION:

Keep receive positions, add PS0413 on dips.

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	12/9/2008	-	5.992%	9/10/2008

Money Market

Credit crunch made the carry extremely cheap

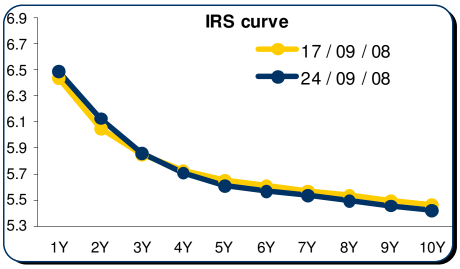
Some hike expectations remain for October meeting

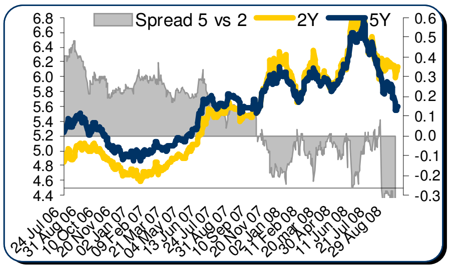
Extremely cheap week behind us and extremely cheap end of the reserve ahead. Reason for this is of course credit crunch continuation, squeeze on dollars and fright of local player that it might spread over pln. Hence, during last OMO only 8 out of 13.9 billion pln of money bill were bought. This means that enormous amount of money flooded the market. Loan to CB was growing every day and despite of the fact reserve was being overbuilt more and more. If our calculations are right there is no hope that tomorrow's OMO will change anything.
As for longer terms waiting for the MPC decision was the main event. Core CPI and retail sales figure were to close to the date, therefore had no impact on rates. The MPC did not change the rates and slight hike expectations were automatically moved towards October meeting. CPI projection will be the highlight of next week.

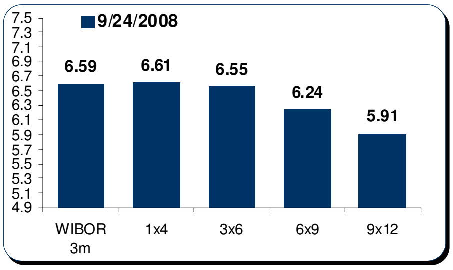
RECOMMENDATION:

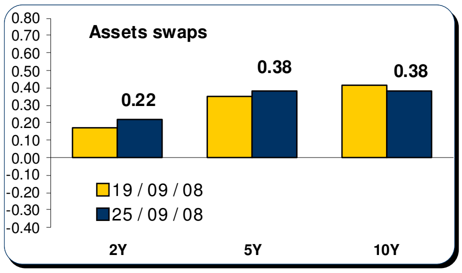
Pay long OIS since it seems that there is too many rate cuts in the curve as of now.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty bit weaker

After quick move to 3.2660 on EUR/PLN on Monday Zloty was weakening and it seems that Zloty has found resistance at 3.3396. Whole week we have seen on that pair sideways trading next to weakening week drift. In addition in USD/PLN we have seen similar moves from 2,2140 and it seems that USD/PLN has found resistance at 2.2833 on Thursday. We haven't seen any spectacular moves like week or 2 weeks ago but it is still very volatile.

Volatility still high

It was another week of high volatility. Curve remained at extreme high levels – EUR/PLN 1M was quoted at 11.50 and 1Y at 7.50 while week before quotations had been at 11.25 and 7.40. USD/PLN 1M moved from 17.00 to 19.50 and respectively 1Y from 14.75 to 14.50.

RECOMMENDATION:

SPOT

Long PLN

Main supports / resistances:
EUR/PLN: 3.2000 / 3.3850
USD/PLN: 2.1850 / 2.3450

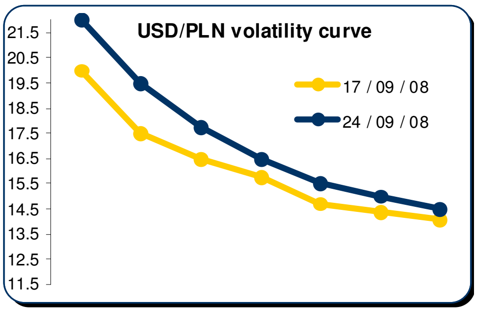
Our trade idea for next days is to buy Zloty at 3.3500 with stop loss around 3.3900 and target at 3.20.

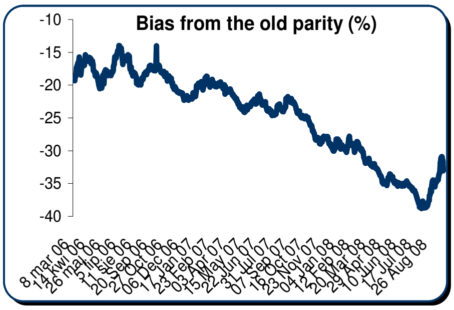
Short vega, short gamma

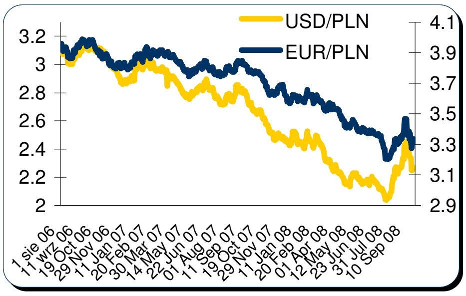
OPTIONS

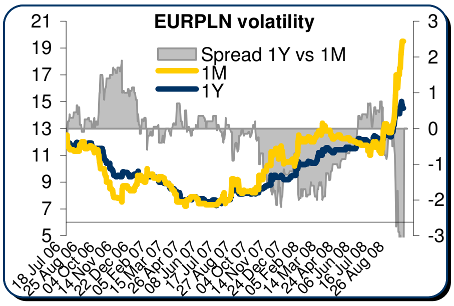
We believe in receiving some benefits from short vega and short gamma positions due to small calm down on spot volatility.

FX CHARTS


USD/PLN volatility curve
17 / 09 / 08
24 / 09 / 08


Bias from the old parity (%)


USD/PLN
EUR/PLN


EURPLN volatility
Spread 1Y vs 1M
1M
1Y

MARKET PRICES UPDATE

MONEY MARKET RATES

Money market rates (Closing mid-market levels)

date	3M		6M		1Y	
	FXSW	WIBOR	FXSW	WIBOR	FXSW	WIBOR
18/09/08	6.46%	6.62%	6.49%	6.55%	6.56%	6.56%
19/09/08	6.52%	6.61%	6.54%	6.53%	6.56%	6.56%
22/09/08	6.43%	6.59%	6.54%	6.53%	6.55%	6.55%
23/09/08	6.49%	6.59%	6.51%	6.52%	6.53%	6.55%
24/09/08	6.48%	6.59%	6.53%	6.52%	6.55%	6.55%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
18/09/08	6.61%	6.55%	6.24%	5.91%	6.12%
19/09/08	6.59%	6.54%	6.22%	5.90%	6.13%
22/09/08	6.59%	6.55%	6.24%	5.92%	6.13%
23/09/08	6.61%	6.56%	6.25%	5.93%	6.14%
24/09/08	6.61%	6.55%	6.24%	5.91%	6.13%

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
18/09/08	6.56%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
19/09/08	6.56%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
22/09/08	6.55%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
23/09/08	6.55%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
24/09/08	6.55%	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
18/09/08	17.50	16.00	15.00	14.50	1.80	1.60	0.30	0.35
19/09/08	18.50	16.25	15.50	14.75	15.00	1.50	0.30	0.35
22/09/08	19.00	16.50	15.50	15.00	15.00	1.50	0.30	0.35
23/09/08	19.50	16.50	15.50	14.70	15.00	1.50	0.30	0.35
24/09/08	19.50	16.50	15.50	14.50	15.00	1.50	0.30	0.35

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
18/09/08	2.3428	3.3710	-31.83%
19/09/08	2.3381	3.3163	-31.15%
22/09/08	2.2480	3.2750	-30.93%
23/09/08	2.2492	3.3099	-30.95%
24/09/08	2.2531	3.3094	-31.62%

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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