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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of November 14th to November 20th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
M3 Supply y/y	**14 Nov**	Oct	**17.5%**	17.8%	17.1%	Substantial growth rate of household deposits driven by the run from investment funds (26% y/y). Firm deposits still running at modest pace – 4.5% y/y.
Employment y/y	**18 Nov**	Oct	**3.8%**	3.7%	4.1%	Softer business tendency indicators in financial intermediation, avalanche continues in transport and manufacturing. High statistical base from the last year works towards lower reading.
Average wage y/y	**18 Nov**	Oct	**8.9%**	9.6%	10.9%	High 2007 statistical base. The trend of wages slowly bends down. W expect the December growth rate of wages At 7-8% y/y.
Industrial output y/y	**20 Nov**	Oct	**-1.2%**	1.2%	7.0%	No difference in working days. Large drops in business tendency indicators concerning current output and prospect manufacturing (new export orders drowning). Surprisingly high reading of the PMI output component make us point to asymmetric upward risk.
Producer prices y/y	**20 Nov**	Oct	**2.0%**	2.4%	2.1%	Higher import prices (EURPLN and USDPLN appreciation) and considerably lower price assessment of firms (business tendency indicators). Low statistical base from 2007; lower regional PPI readings (e.g. Czech Rep.).

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In Focus / Macroeconomics

October CPI data not surprising

CPI inflation hit 4.2% y/y in October after 4.5 recorded in September. Whereas food and fuel prices came in line with our expectations, energy prices were much harder to predict – they rose 1.7%, lifting the housing maintenance costs 0.9% upwards. It is interesting that core "categories" connected mainly with services, showed only modest increases (or even monthly drops). We expect core "net" inflation to top 4.4% y/y (mainly on energy prices) and the new measure (excluding energy and food) to ease to 2.9% y/y.

Headline figure will be brought downwards in coming months by food, fuel prices and statistical effects. Net core inflation is going to stay elevated though, owing to increases in state-regulated prices. Higher inflation is unlikely to enter a self inducing spiral as wage demands are likely to be left unfilled as economy is heading towards softer GDP growth which enacts cost cutting procedures. There is a room for monetary easing this year, however, elevated core inflation is still likely to propel some hawkish comments. It is the real sphere to decide. Should the historical PMI-GDP correlation hold in the future, we may see a sharp softening of economic activity in Q4 2008 and Q1 2009. This will clear the way for repo rate cuts. We even do not rule out a small, 25 bp. step in November.

Judging by the current shape of the yield curve (despite higher zloty volatility market has priced in massive rate cuts to come) the eventual rate cuts will only have very limited additional effectst on the zloty exchange rate. We see however zloty weaker due to cyclical and flow related factors in the coming months (see the piece below).

Fundamentals and EMU entering issues speak for elevated FX volatility

The C/A data released yesterday were far from being a real shocker. The reading actually met market expectations by reaching -1.9 bn EUR. As for its components we saw (a bit surprising though, but in current conditions - unsustainable) narrower trade deficit which resulted mainly from elevated exports. As for the other C/A items, they were worse than in the previous month. The closely followed C/A deficit to GDP ratio stood in September at 5.1% - taking into consideration the recent developments (in domestic and the global economy as well), this is hardly the target level of the aforementioned relation. We expect the downward move to continue.

Really scary figures are likely to pop into daylight in coming months. First of all, we experienced a sharp depreciation of the domestic currency. The so called J-curve effect is then likely to exert significant downward pressure on trade balance items in coming months (owing to relatively dearer imports in terms of domestic currency or, equivalently cheaper exports in foreign currency). If the effect was to work out perfectly, we would see a slowly narrowing balance of trade deficit in longer term owing to the increased competitiveness of exports in longer term and consumers shifting towards domestic (and relatively cheaper) goods. Such a scenario may be hard to materialize though owing to the weakness of the overall economy and relative strength of Polish consumption (at least considerably outpacing the foreign one). To sum up: the bottom of trade balance (and hence C/A as well) may be more severe than the one stemming form J-curve effect; we may expect a slower improvement as well. It is rather obvious that such a tendency may trigger foreign investors to sell of the zloty as a currency based on weaker footings. It is not the end of the story…

The ruling Civic Platform was given a lot of confidence by foreign investors just after the elections, which of course included (among other issues) its drive to fast euro adoption. The wish seemed to be coming true when D. Tusk announced the euro adoption in 2011. Shortly after the road map to euro was issued…the process suddenly stuck in a deadlock. There are more and more obstacles including legal and political ones. The bucket of cold water was also poured by J-C. Trichet who thinks all these issues has to be settled before thinking about ERM2 entry. It is now quite clear that we would not enter EMU by back door and have to conform to all the criteria, including the legal ones (which is extremely hard owing to the lack of political consensus).

It is then reasonable to expect the elevated levels of volatility in the FX market, not only due to deteriorating fundamentals, but also because of political measures (the will to enter EMU fast) which apparently had been designed to help, but now may bode ill for the expectations on the domestic currency.

MEDIUM-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.1	3.0
Inflation rate (%, average)	1.0	2.4	4.4	2.9
Current account (% of GDP, average)	-2.1	-4.5	-4.6	-5.3
Unemployment rate (end-of-year)	14.9	11.4	9.4	9.6
NBP repo rate (end-of-year)	4.00	5.00	6.00	4.75

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.8	4.8	4.0	3.5	3.5
Inflation rate (%, average)	4.3	4.7	3.8	3.5	3.3
NBP repo rate (end-of-quarter)	6.00	6.00	5.75	5.25	5.00

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

Fixed Income

Finally a calm week on the FI market.

Last week was rather calm on FI market. Curve stayed in rather steady range and "holiday period" help a little to calm the market. Turnover bonds in bonds and IRS stayed very timid, with most of the flow being dominated by liquidation of long positions in bonds. CPI figure came rather unnoticed, with market pricing easing still this year despite comments from hawkish side of the MPC. We still stay on the side ways of the market. We see little reason to put outright bets on the curve. We start to like steeper curve, with rate cuts pushing front end of the curve lower while problems with financing the deficit and the deficit itself will be becoming more and more an issue further into next year. We also think that ERM2 entry is getting less and less likely and we cannot rule out announcement about postponing the plan due to lack of political consensus which will put further pressure on the far end of the curve.

RECOMMENDATION:

Open 1y ag 10y at current level (-50bp)

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.560%	10/27/2008
26 Week T-bills	-	-	6.409%	9/15/2008
52 Week T-bills	11/17/2008	-	6.395%	10/20/2008
2Y T-bond OK0710	12/3/2008	-	6.471%	8/6/2008
5Y T-bond PS0413	2/6/2009	-	5.926%	10/1/2008
10Y T-bond DS1019	2/13/2009	-	6.054%	4/9/2008
20Y T-bond WS0429	12/9/2008	-	5.992%	9/10/2008

Money Market

Waiting for the MPC

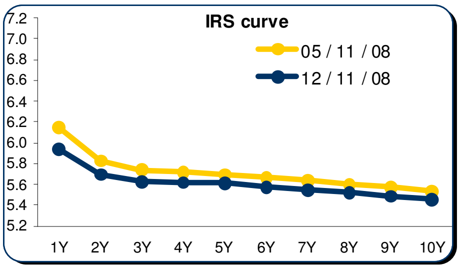
Repo operation released additional cash

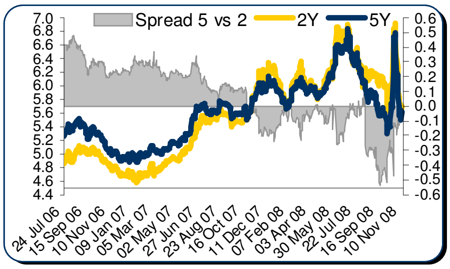
Shorter week due to national holiday brought not too many changes for longer rates. Market is still very slow and waiting seems to be the main activity.
However, for the cost of carry, Friday's open market operation changed a lot. Market bought 13 billion pln of money bills, against maturing papers worth slightly above 6 billion pln. This made the cash surplus disappear so as cheap carry. Rates shoot up from 5% to 7% just to stabilise nearby 6.5%. There was another repo operation on Tuesday which provided additional 5 billion pln for 91 days. This helped carry to get back to the main rate area. Tomorrow's OMO will show the trend for coming week.

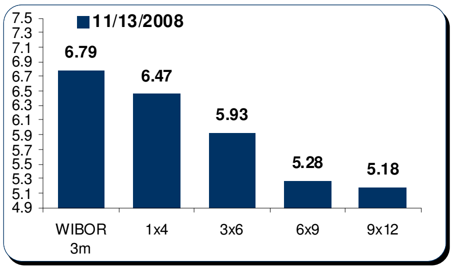
RECOMMENDATION:

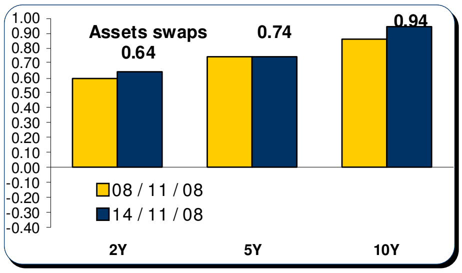
Sell 6m Polonia at current levels.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty slightly weaker

This week zloty opened around 3.6000 levels and weakened toward 3.8400 on low liquidity market (Polish holiday). However move looks impressive bigger picture of PLN stays unchanged. It's still driven by global sentiment shifts and all levels between 3.50-4.00 are equally likely.

Volatility in a range

Volatility curve has been traded much about in range– EUR/PLN 1M was quoted between 27-37 and 1Y respectively 16-19. USD/PLN 1M was traded at 42.00 and 1Y at 26.00.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 3.5300 / 3.8000
USD/PLN: 2,5000 / 3.1000

Play range

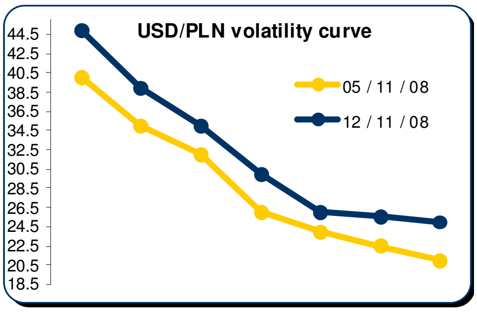
We suggest playing wide but narrowing EURPLN. Numbers for this week are 3.55-3.80

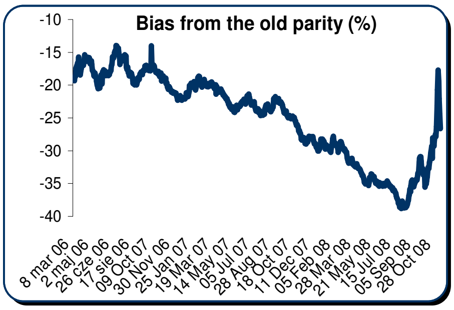
Short vega

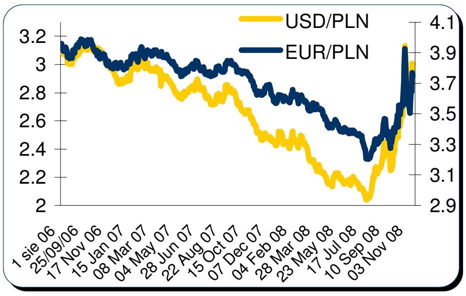
OPTIONS

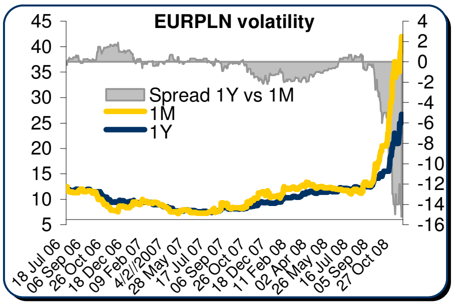
We believe in receiving some benefits from short vega especially on 6M and 1Y selling.

FX CHARTS


USD/PLN volatility curve
05 / 11 / 08
12 / 11 / 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
05/11/08	6.73%	6.84%	6.74%	6.76%	6.77%	6.79%
06/11/08	6.67%	6.83%	6.70%	6.49%	6.75%	6.59%
07/11/08	6.67%	6.83%	6.70%	6.74%	6.75%	6.79%
10/11/08	6.65%	6.82%	6.70%	6.74%	6.73%	6.78%
12/11/08	6.64%	6.79%	6.70%	6.73%	6.73%	6.77%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
05/11/08	6.61%	6.11%	5.65%	5.52%	5.61%
06/11/08	6.52%	5.97%	5.47%	5.35%	5.42%
07/11/08	6.50%	6.00%	5.48%	5.30%	5.49%
10/11/08	6.51%	6.02%	5.39%	5.27%	5.40%
12/11/08	6.51%	5.97%	5.50%	5.30%	5.40%

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
05/11/08	6.79%	5.08%	5.57%	5.29%	5.72%	5.69%	5.73%	5.76%
06/11/08	6.59%	5.05%	5.57%	5.29%	5.71%	5.68%	5.72%	5.76%
07/11/08	6.79%	5.05%	5.57%	5.34%	5.71%	5.67%	5.71%	5.76%
10/11/08	6.78%	5.05%	5.56%	5.30%	5.71%	5.65%	5.72%	5.75%
12/11/08	6.77%	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	08/10/20	09/10/20	93.920	6.40%	1000	739	495
OK0710	08/08/06	10/07/25	88.390	6.47%	1800	3724	1830
PS0413	08/10/01	13/04/25	99.132	5.93%	1800	4924	1856
DS1017	08/10/08	19/10/26	97.121	5.86%	2500	4472	2500

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
05/11/08	35.00	26.00	24.00	21.00	7.00	6.50	0.80	0.80
06/11/08	35.00	26.00	24.00	23.00	7.00	6.50	0.80	0.80
07/11/08	37.00	26.00	24.00	25.00	7.00	6.50	1.00	1.00
10/11/08	39.00	28.00	24.00	25.00	8.00	7.50	1.00	1.00
12/11/08	39.00	30.00	26.00	25.00	9.00	8.50	1.20	1.20

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
05/11/08	2.7306	3.5046	-20.72%
06/11/08	2.7571	3.5603	-17.75%
07/11/08	2.8428	3.6474	-19.46%
10/11/08	2.8332	3.6427	-22.09%
12/11/08	3.0065	3.7693	-24.49%

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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