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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of January 23rd to January 29th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
MPC Decision	**Jan 27**	-	**4.25%**	4.50%	5.00%	The MPC cannot ignore the recent deterioration of business outlook. As is the case in most economies now, rate-setters are going to focus on short-term business activity what favors 75pb cut (or larger one)
Retail sales y/y	**Jan 29**	Dec	**2.5%**	6.1%	2.7%	Substantial deterioration of business tendency indicators. Possible falls in sales connected to large stores dealing with construction goods likely to offset the positive difference in working days.

In Focus / Macroeconomics

Polish growth outlook deteriorates further

Recent real sphere data confirmed the shaky state of Polish economy. Industrial output sharply contracted and another outright fall in employment was recorded. Ailing business conditions and softening labor market are going to strengthen the disinflation process – yet core inflation is falling, so is the wage growth rate. In these circumstances it seems that the MPC has no other option than focus on the gloomy short-term economic outlook and react to countervail the recessionary threats. We see a chance for at least 75bp cut in the coming meeting. Substantial FX volatility should not constitute an obstacle as the zloty depreciation should be seen (and is actually seen by the majority of the MPC) as a natural force leading the economy towards equilibrium. Such a view is partially confirmed by the last MPC “Minutes” in which the majority of members favors substantial rate cuts as gradual easing may only exacerbate zloty depreciation.

Corporate sector shed in December 34k jobs bringing annual growth rate to 2.3% y/y (after 3.1% recorded in November). Demand for labor is clearly softening and group lay-offs, embodied so far only in the realm of anecdotal evidence, are slowly being implemented (and this is clearly not the end). Lower demand goes hand in hand with lower remuneration. Growth rate of wages posted annual growth of 5.4% y/y after 7.8% recorded last month. The evidence in favor of lower dynamics of wages is mainly cyclical including rapid deterioration of economic activity in the final months of the year. Lower growth rate was also supported by statistical effects: earlier payment of bonuses in mining and postponement of some wage transfers till January 2009 as it was beneficial for some employees owing to the change in the tax rates.

Drops in employment do not appear to be accidental. Industrial output also went down by 4.4% y/y in December despite positive difference in working days. Seasonally adjusted figure amounted to -7.4 y/y proving constant deterioration of business conditions. We see this trend to go in full throttle in coming months on reduced exports and limited investment activity of Polish companies. The Labor market will follow due along with industrial output and private consumption.

Prices at different stages of production and distribution remained relatively well contained. As for the producer prices, they decreased for the third consecutive time on monthly basis – the rise of annual figure owes much to the upward revision of November estimates. As far as core inflation goes, the fall of the main measure (CPI excluding food and energy) reflects so far mainly ripple effects stemming from cheaper fuels. Decelerating economy is to exert higher pressure on prices in the months to come, allowing CPI – among benign prices of food and duels – to meet the MPC target in H2 2009.

This week the long awaited data on the state budget balance saw the light. It is evident that the bumpy state of the economy is starting to adversely affect public finances. Although the 2008 budget deficit itself proved to be slightly lower than originally assumed (24.6 bn PLN vs. some 27 bn PLN), the revenues breakdown has some flavor of perils ahead of the 2009 budget bill. There is a large shortfall in revenues from indirect taxes suggesting that lower consumption and construction activity may drag down this income base also in 2009 by more than previously expected. Furthermore, from today’s perspective it seems that relatively low deficit in 2008 was sustained mainly on lower spending: there are rumors that some ministries were left with unsettled liabilities for the previous year. Owing to the sharp deterioration of business outlook, and simply flawed assumptions about counterbalancing powers of private consumption, 18.2 bn PLN deficit assumed for 2009 is overly optimistic (Fitch rating agency does not share government’s optimism but leaves so far rating and its perspective intact, though). Our suggestion is to closely follow the budget realization and revenues in particular in the months to come. Although theoretically it is possible for the government to handle lower revenues through cuts in spending, the scale of revenue shortfall, which we estimate at more than 15-20 PLN bn, makes the budget bill amendment the most likely scenario. Given the current mood of financial markets it may be pretty nasty scenario for both the long end of the Polish government yield curve and the zloty.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009
GDP y/y (%)	6.1	6.5	5.0	<1.5
Inflation rate (%, average)	1.0	2.4	4.3	2.9
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-5.7
Unemployment rate (end-of-year)	14.9	11.4	9.5	12.2
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.00

Indicator	2008			2009	
	Q2	Q3	Q4	Q1	Q2
GDP y/y (%)	5.8	4.7	3.0	1.5	1.0
Inflation rate (%, average)	4.3	4.7	3.8	3.1	2.7
NBP repo rate (end-of-quarter)	6.00	6.00	5.00	**3.25↓**	**3.00↓**

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

Fixed Income

Can MPC surprise the market?

Last week was rather interesting on the FI market. Bullish rally continued on bonds with asset swaps still tightening and yield curve touching lows in the 2y at 4.05%, steepening trade was still in fashion. After heavy supply from the primary market auction and switch auction started to weight on the market so Wednesday and Thursday market started to correct with longest bonds leading the sell off. The announcement of new Euro benchmark bond which Ministry of Finance is planning to issue at Libor + 300/325 points also added pressure to already heavy market. Wibor rates on the other hand started to ease substantially making weekly decline of more than 20 bp. Next week most anticipated event will be RPP meeting and with expected 50 bp (at least) cut. While we think lowering of main repo rate is important, the more interesting fact will be deeper cut of the lower rate (so called **deposit rate**, currently standing at 3.5%). RPP members expressed few times their negative stance towards lowering the minimal reserve requirements underlining the fact that they are keen to see money market coming back to shape. We think that lowering deposit rate more than repo rate can be one of the means to persuade banks to activate lending policies on the bigger scale rather than putting money back to NBP especially after KRN bonds buyback. We think such a development would make Wibor rates push lower even more substantially and short bonds to significantly outperform longer ones.

RECOMMENDATION:

Stay receive in front end of the curve, hold short bonds ASW

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	6.197%	12/9/2008
52 Week T-bills	1/26/2009	-	4.748%	01-19-09
2Y T-bond OK0711	2/4/2009	-	5.054%	1/7/2009
5Y T-bond PS0413	2/4/2009	-	5.616%	12/17/2008
10Y T-bond DS1019	2/11/2009	-	5.724%	12/17/2008
20Y T-bond WS0429	2/11/2009	-	5.369%	1/14/2009

Money Market

Carry up, KRNBP0312 buy-out impact awaited

More then 50 bps cut next week?

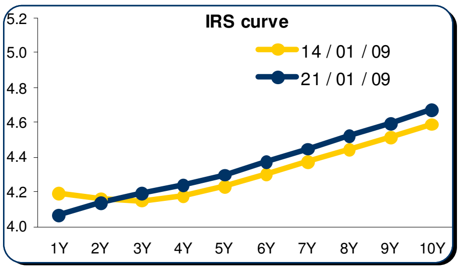
Shortest rates up after 17.5 billion pln of money bills were sold. Even square market right now means relatively expensive carry, therefore tomorrow's auction will be crucial, especially when we see the KRNBP0312 buy-out impact.

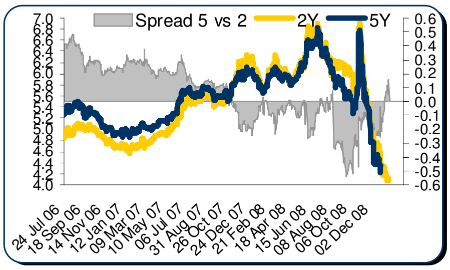
As for longer terms, bullish but without any substantial turnover. Lower wages (5.4 vs 6.9% expected), weaker industrial output (-4.4 against -1.8% expected) plus lower core CPI, all leaves no doubts for the nearest future. 50 bps cut is more then certain next week and we see some chances for a bigger move.

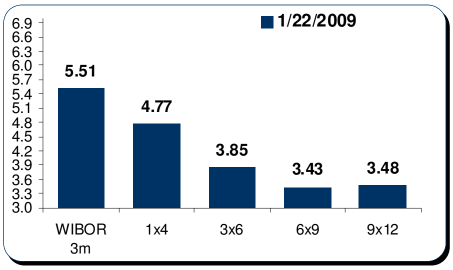
RECOMMENDATION:

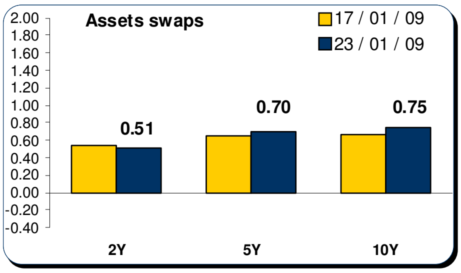
Sell 6M polonia.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This week zloty opened at 4.2400 and weakened towards 4.4400. It is still a matter of bad investment sentiment and uncertainty of budget deficit number.

Volatility untouched

Despite of weaker spot, realized volatility stays below/at implied level, so 1Y is still traded at 19-20 and 1M price range is 28-34.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.1500 / 4.5500
USD/PLN: 3.1600 / 3.6000

Short EURPLN/stay away

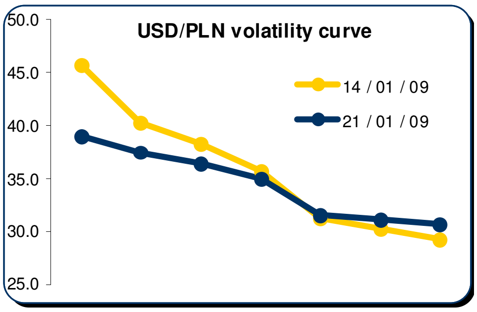
We see 4.50/4.55 as medium term target, so rest of market do. We suggest selling between 4.50/4.55 with 4.65 S/L and 4.15 P/T. Otherwise we suggest waiting for signals 4.55 won't be broken and selling then.

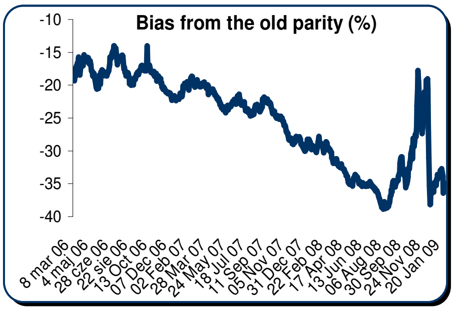
Short vega

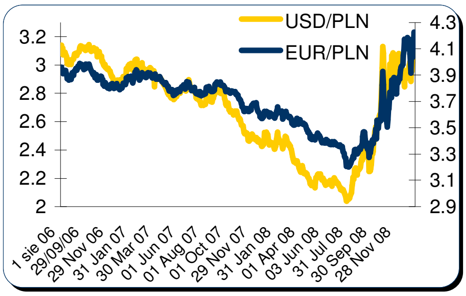
OPTIONS

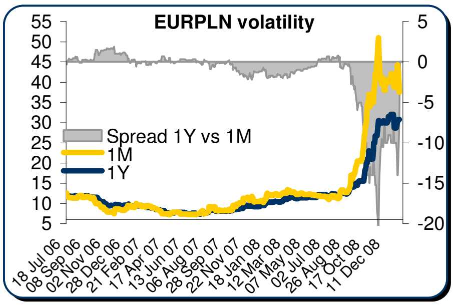
We believe in receiving some benefits from selling vega, especially 6M-1Y tenors.

FX CHARTS


USD/PLN volatility curve
14 / 01 / 09
21 / 01 / 09
50.0
45.0
40.0
35.0
30.0
25.0


Bias from the old parity (%)
-10
-15
-20
-25
-30
-35
-40


USD/PLN
EUR/PLN
3.2
3
2.8
2.6
2.4
2.2
2
4.3
4.1
3.9
3.7
3.5
3.3
3.1
2.9


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
15/01/09	5.47%	5.63%	5.69%	6.49%	5.59%	6.59%
16/01/09	5.52%	5.57%	5.65%	5.58%	5.65%	5.62%
19/01/09	5.45%	5.56%	5.58%	5.56%	5.58%	5.60%
20/01/09	5.40%	5.55%	5.65%	5.53%	5.57%	5.57%
21/01/09	5.38%	5.51%	5.52%	5.52%	5.54%	5.55%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
15/01/09	5.08%	4.03%	3.38%	3.43%	3.47%
16/01/09	4.98%	3.93%	3.28%	3.33%	3.37%
19/01/09	4.93%	3.98%	3.29%	3.34%	3.44%
20/01/09	4.80%	3.85%	3.22%	3.26%	3.35%
21/01/09	4.81%	3.88%	3.38%	3.41%	3.44%

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
15/01/09	6.59%	4.89%	4.17%	4.75%	4.25%	4.92%	4.62%	5.31%
16/01/09	5.62%	4.89%	4.08%	4.62%	4.20%	4.84%	4.57%	5.23%
19/01/09	5.60%	4.89%	4.10%	4.61%	4.15%	4.84%	4.58%	5.24%
20/01/09	5.57%	4.89%	4.10%	4.57%	4.23%	4.90%	4.59%	5.31%
21/01/09	5.55%	4.89%	4.14%	4.65%	4.30%	5.00%	4.67%	5.42%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/01/19	10/01/19	95.419	4.75%	500	2627	500
OK0711	08/12/09	11/07/25	86.996	5.47%	2500	8037	2930
PS0413	08/12/17	19/10/25	100.558	5.62%	2500	3578	1742
DS1017	08/12/17	19/10/25	98.186	5.72%	4500	3521	2340

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
15/01/09	44.25	37.75	32.25	30.25	8.00	8.00	1.40	1.40
16/01/09	44.25	37.75	32.25	30.25	0.00	0.00	0.00	0.00
19/01/09	42.50	37.50	32.25	30.75	0.00	0.00	0.00	0.00
20/01/09	39.50	36.00	32.00	30.75	0.00	0.00	0.00	0.00
21/01/09	37.50	35.00	31.50	30.75	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
15/01/09	3.2011	4.2256	-32.72%
16/01/09	3.1353	4.1522	-33.30%
19/01/09	3.2473	4.3113	-33.85%
20/01/09	3.3381	4.3280	-36.38%
21/01/09	3.3468	4.3305	-34.78%

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)

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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