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FINANCIAL MARKETS DEPARTMENT

PAGES: 8

WARSAW, MARCH 20, 2009

POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of March 20th to March 26th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Core inflation y/y	**Mar 20**	Feb	**2.6%**	2.5%	2.6%	Although February saw some rises in core categories, the falling trend will be left intact on slowing demand pressures and deteriorating labor market.
Retail sales y/y	**Mar 24**	Feb	**3.0%**	-1.3%	1.3%	Stronger sales of autos, price effects in case of fuels (+8% m/m) and recent advances in small cross-border trade are likely to lift retail growth relatively high with relation to the consensus.
MPC decision	**Mar 25**	-	**3.75%**	3.75%	4.0%	Should the zloty remain stable, the MPC will cut 25bp. as a precautionary mean agains a deeper slowdown (higher PPI is likely to be perceived through exchange rate effects and its stability).

In Focus / Macroeconomics

Weaker zloty (temporarily) distorts the disinflation

Both producer and consumer prices marked their monthly record rise in February. PPI prices shot up by 2.3% m/m (0.7% in prior month) on rising prices in manufacturing, way beyond market consensus and our quite elevated forecast. The rise in prices matches well the advance in energy costs from January and February (by compounded 12%) and some contemporary and lagged effects of the record zloty depreciation. Taking into consideration the shortage of demand and elevated level of stocks, we would rather see the rapid price growth as temporary (we still do not see a trend, apart from monthly surges easily connected to exogenous factors and their influence on mark-ups in all industries, unlikely to play a significant role in coming months). However, the lack of coordination between firms when it comes to price setting implies there may be still some upward pressure to emerge. For an external spectator it may indeed look like as if the disinflation process ended. It is then more reasonable to track business tendency indicators which may better reflect the erosion of firms' pricing power.

The exchange rate pass-through to consumer prices, though not negligible, seems to be so far more limited than that onto producer prices. Business tendency indicators in retail activity still do not signal any significant break in the falling trend in indices concerning prices. It makes us conclude there are still buffers within the distribution chain that keep price margins in check (we admit though there is a risk that some prices of tradables may be lifted even in times of growing overcapacity as some goods, especially attractive in cross-border trade, will be able to retain their price competitiveness even despite price hikes).

CPI inflation reached 3.3% y/y in February meeting market consensus. The annual figure is somehow misleading as prices are still running at 0.9% m/m with core categories, energy and fuels leading the way. Only limited annual growth of CPI is a result consumer basket's revision (weights attached to food came in considerably lower whereas those for energy, fuels, health and communications rose). Due to a front loaded state controlled price increases, CPI inflation is likely to stay on elevated levels for some time. On the other hand, falling core inflation trend that results from lessening demand pressures and capped wage growth as well (of which indication we got in February's data when corporate wages slowed down to 5.1% y/y) should be left more or less intact in the mid-term.

Softer real sphere figures, first signs of C/A rebalancing

Industrial output dropped in February by 14.3% y/y vs. 15.3% fall recorded in January. Monthly increase of 2.7% should be seen as a very modest one if accounted for seasonal factors and a sharp fall in January. The weakness seems to spill over to vast majority of sections. Those producing capital goods and linked to external demand, such as metal industry and auto manufacturing, belong to the ones being particularly affected by deteriorating demand in Western Europe. Turning to the short-term perspectives, we expect annual figures to improve slightly due to statistical base effects. Momentum remains negative, though.

The ongoing slowdown in exports has been even outweighed by a sharp deterioration of imports. Thus, C/A deficit in January narrowed by more than expected reaching -1087 mln EUR. The improvement owes much to narrowing trade deficit which amounted to -441 mln EUR in January on the back of sharply falling imports (-26,6% y/y) which contracted faster than exports (-25,2% y/y). We think there is still more room for a rapid trade balance improvement stemming from limited growth of consumption (rising saving rate, unemployment and quite a rapid acceleration of layoffs – in February employment fall by 0.2% y/y), sings of stabilization in manufacturing and J-curve effects reflected in exports. The prospects for trade surplus wipe out many concerns on the financing side of the BOP. In the light of recent developments there is no need for the zloty to depreciate further to make the accounts of the BOP meet. We think that financing may be endangered but for a very limited period of time till the dynamic adjustments in trade balance take place (we may expect also some positive contributions of income account to emerge on the back of reduced receipts on net foreign borrowing). The perspective of such a balance of payments adjustment (accompanied by the IMFs emergency credit lines and government's commitment to sustain low budget deficit) justifies any temporary depletion of currency reserves, what should not be viewed negatively by investors, thus supporting the exchange rate.

This weeks data, and much higher reading of PPI in particular, have a potential to induce some fierce discussion during the March MPC meeting. We think, however, that the Committee will link the PPI increase solely to zloty depreciation and that is why the rate cut, given the dovish bias of the Committee, is still possible conditional on (globally) decreasing risk aversion and more stable zloty exchange rate.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	0.0	3.0
Inflation rate (%, average)	1.0	2.4	4.3	3.0	2.0
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-4.9	-4.5
Unemployment rate (end-of-year)	14.9	11.4	9.5	13.5	13.9
NBP repo rate (end-of-year)	4.00	5.00	5.00	3.50	4.00

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	1.0	-0.5	-1.0	0.7
Inflation rate (%, average)	4.7	3.8	3.3	2.8	2.5	2.4
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.50	3.50

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

Fixed Income

Surprise after surprise, not all good unfortunately.

Last week was saw quite interesting turnaround in sentiment. After very good switch auction sentiment started to deteriorate. Despite PLN strengthening we saw some profit taking on the bonds especially in the longer end of the curve. Additionally curve steepened in 2y5y sector currently trading at 50bp (38bp last week). Economic releases brought a little noise to the market with revision of CPI basket and very high reading of the PPI. Short end of the curve pushed higher in yields with 3x6 trading at the high at 3.95% pricing only 25 bp easing in the current cycle. We are generally still bullish on risk and with current market doubts about scale of easing we see risk on rather bigger easing in the coming quarter. Therefore we still like holding 5y bonds at current levels (PS0414 is now 30 cents lower since we recommended receive position in bonds) we also like to ad 3x6 receive position at current levels. We see RPP as dovish and mostly focusing on the widening output gap. PLN stabilization should allow RPP to continue cutting rates and with risk aversion calming down a little we see potential for capital gains in the bond market.

RECOMMENDATION:

Stay receive in PS0414, sell 3x6 PLN FRA

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.357%	3/16/2009
52 Week T-bills	3/23/2009	-	4.827%	3/16/2009
2Y T-bond OK0711	4/1/2009	-	5.804%	3/4/2009
5Y T-bond PS0413	4/1/2009	-	6.053%	3/4/2009
10Y T-bond DS1019	4/8/2009	-	5.724%	12/17/2008
20Y T-bond WS0429	4/8/2009	-	5.369%	1/14/2009

Money Market

Carry still very low

Another very cheap week for liquidity. As was expected the central bank again significantly restricted the amount of money bills during weekly tender. Reduction rate was 62%, and polonia index jest slightly above the deposit rate on a daily basis. No change expected soon.

Some figures showed up in the meantime. Wages at 5.1% in line with expectations, industrial output -14.3% close enough to predicted -16.4%, and the only surprise in PPI which was 5.4% against 3.3% expected. The last figure will definitely support the hawkish wing of the MPC, however we still see majority for another 25 bps cut.

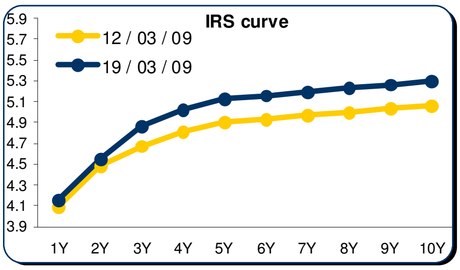
PPI was the only surprise

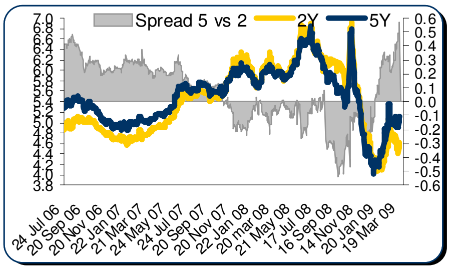
52-week T-bills average yield dropped to 4.82% during last tender, from previous 4.94%.

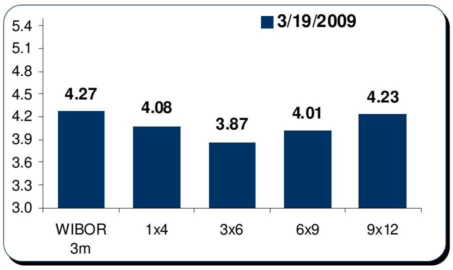
RECOMMENDATION:

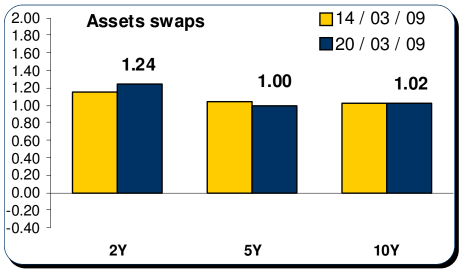
Sell 3M, buy 6M polonia at current levels

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This week zloty has opened at 4.4600, hit low at 4.4200 and weakened toward 4.6800. Reason behind this move was closing EURPLN shorts opened on equities rally last week.

Implied volatility lower

Although zloty weakened, global sentiment remains good, so vols stayed at pretty the same levels with 1M traded at 26-27, and 1Y at 21-22.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.4000 / 4.8000
USD/PLN: 3.1000 / 3.5500

Short EURPLN

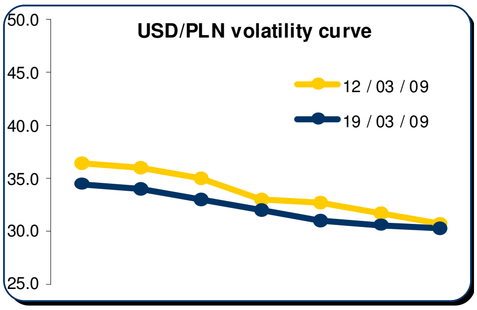
EURPLN correction target is 4.66-4.70, but our favorite short entry level is 4.80. Until then watch market behaviour around 4.66. If global sentiment remains on same level we will sell even there.

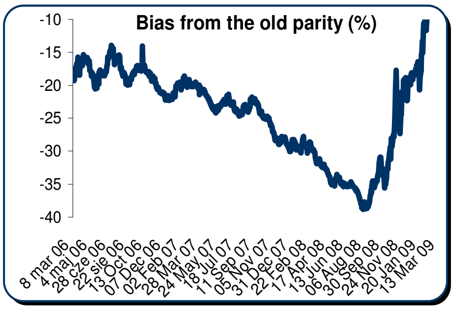
OPTIONS

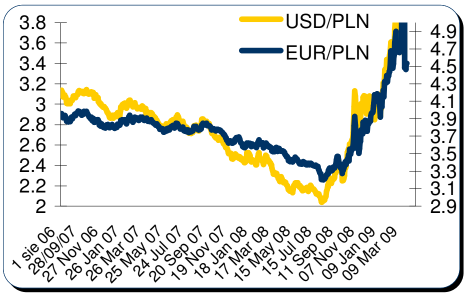
Short vega

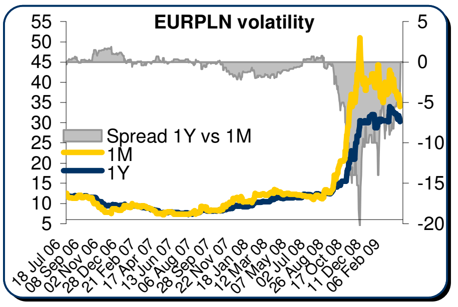
Vols looks a bit offered here, we suggest wait for higher levels to entry short vega.
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market. Exporters may have some benefits from selling Risk Reversals as it is nearly highs (7 vols favour call).

FX CHARTS


USD/PLN volatility curve
12 / 03 / 09
19 / 03 / 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


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
13/03/09	4.19%	4.33%	4.26%	6.49%	4.28%	6.59%
16/03/09	4.15%	4.33%	4.26%	4.28%	4.26%	4.29%
17/03/09	4.14%	4.30%	4.22%	4.26%	4.23%	4.27%
18/03/09	4.13%	4.28%	4.22%	4.25%	4.28%	4.27%
19/03/09	4.12%	4.27%	4.22%	4.26%	4.24%	4.27%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
13/03/09	4.18%	4.00%	4.08%	4.33%	4.24%
16/03/09	4.06%	3.85%	3.96%	4.17%	4.07%
17/03/09	4.01%	3.82%	3.94%	4.13%	4.05%
18/03/09	3.95%	3.75%	3.85%	4.05%	4.00%
19/03/09	3.98%	3.79%	3.84%	4.04%	3.97%

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
13/03/09	6.59%	4.88%	4.47%	5.62%	4.91%	5.95%	5.07%	6.10%
16/03/09	4.29%	4.66%	4.41%	5.59%	4.90%	5.90%	5.07%	6.07%
17/03/09	4.27%	4.80%	4.53%	5.64%	5.02%	6.01%	5.18%	6.21%
18/03/09	4.27%	4.80%	4.63%	5.79%	5.12%	6.12%	5.30%	6.32%
19/03/09	4.27%	4.80%	4.55%	5.79%	5.12%	6.12%	5.30%	6.32%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/03/16	10/03/16	95.354	4.83%	1200	3200	1181
OK0711	09/03/04	11/07/25	87.404	5.80%	3800	3199	2090
PS0414	09/03/04	14/04/25	98.663	6.05%	2500	1305	640
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
13/03/09	37.00	34.00	33.75	31.75	0.00	0.00	0.00	0.00
16/03/09	37.00	34.00	33.00	31.75	0.00	0.00	0.00	0.00
17/03/09	36.00	33.50	32.00	31.25	0.00	0.00	0.00	0.00
18/03/09	35.00	32.75	31.75	30.75	0.00	0.00	0.00	0.00
19/03/09	34.00	32.00	31.00	30.25	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
13/03/09	3.4721	4.4833	-0.73%
16/03/09	3.4625	4.4940	-0.91%
17/03/09	3.4373	4.4653	-0.53%
18/03/09	3.4774	4.5313	-1.72%
19/03/09	3.3657	4.5352	-4.19%

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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