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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

PREVIEW: The week of April 24th to April 30th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Retail sales y/y	**Apr 27**	Mar	**-3.0%**	0.2%	-1.3%	Despite higher number of working days, base effect (different timing of Easter) and falling consumer confidence are most likely to bring retail sales growth under 0 again.
MPC decision	**Apr 28**	-	**3.50%**	3.75%	3.75%	We think poor retail sales data may yip the scale towards another reduction in repo rate, although the picture is blurred at the moment and the outcome is better to be guessed than forecast.

In Focus / Macroeconomics

Scary 2008 deficit figures

Although general government deficit for 2008 has only historical flavor, it casts more light on the current state of Polish fiscal policy. When we take into account that the Demember's update of the convergence program estimated the deficit figure at 2.7% of GDP, yesterday's data is somehow striking. 3.9% puts Poland in a more difficult position than Hungary (which recorded 3.4% deficit at the same time) and makes the Polish star only smolder among regional peers.

The divergence from earlier forecast issued by the Ministry of Finance stems from several factors:
- worse central government deficit (on accrual basis) resulting from lower social contribution rate (roughly about 18 bn PLN less in comparison with 2007), some tax reliefs (children benefit) and higher liabilities generated by some Ministries at the end of the year (4-5 bn PLN)
- deficit on local government level which turned out instead of projected surplus (some funds 2008 which were not spent were classified as deficit)
- higher than expected VAT reimbursements,
- higher deficit in Social Fund.

Although higher liabilities of some ministries have been already paid, which influenced the budget deficit on cash accounting basis, other factors including the growing deficit of governments on a state level constitute a negative proxy for the general government deficit in 2009. Therefore our quite pessimistic estimates have a growing probability to come true. The central government deficit will be negatively influenced by the shortage of revenues, driven by considerably softer consumption (lower VAT), worse financial results of firms (lower CIT), and growing unemployment rate (both lower VAT and PIT). Finally, one should add a 1pp. local governments deficit to get the whole picture and 4.5% deficit in 2009. Higher deficits for both 2008 and 2009, accompanied with the recent EU Commission forecasts placing the general government deficit above 3% mark also in 2010, are likely to put Poland again under the Excessive Deficit Procedure. Such a recommendation may be issued by the European Commission at the turn of May and June and makes ERM2 entry unlikely (and pointless).

Although Poland may, at least theoretically, enter the ERM2 mechanism being under the EDP procedure, such a move will not trigger all the positive effects associated with the event not earlier as few days ago. Nowadays investors are likely to be more worried about the effects the economic slowdown will have on the quick reduction of the budget deficit and eventually on the timely adoption of the euro.

As the new estimates of the general government deficit were most probably known to the FinMin at least a month ahead of the official release, it sheds the new light on the most recent move to apply for the FCL. It seems that the FinMin had not anticipated the decline of the global risk aversion that followed after it had applied for the FCL to compensate for the eventual abrupt reaction of the investors to negative budget deficit news. All in all things do not look as favorable as they seemed only few days ago.

Turning to the near term perspectives, we see the budget issues and rising bond supply to weigh on Polish market, although these factors are to coincide with the changes in the global risk aversion. We stick to our strategic idea of shifting the allocation towards bonds in the mid term as the narrowing spread between revenues and fixed costs and eventually depressed earrings of enterprises operating under 5%+ strategic assumptions will set the limit for the stock market rally in Poland and the global investors may eventually go for higher yields of more secure emerging markets. We are skeptical, however, as far as the tactical buying of the polish bonds is concerned. We expect the budget standing to deteriorate significantly in the second quarter of 2009 because government's willingness to cut the spending is unlikely to offset the fall in budget revenues which are set to be massively under the plan. We also reiterate our call for budget to be amended this year with the government approaching this issue as soon as in June.

Industrial output as a doubtful sign of recovery

Better industrial output figure fully confirm the recent publications worldwide. However, we are rather skeptical as for the perspectives for the real sphere in 2009. Sloppy consumption, trimmed investment expenditures and ongoing deterioration in the labor market are likely to put a break on economy for some time. A good time for rebound is still H2 2009, although the pace of recovery will be – consistent with recent IMF findings – sluggish as in case of most recoveries after financial crises.

Industrial output fell by 2% y/y after -14.3% recorded in February. Better reading stems mainly from higher number of working days and later Easter (seasonally adjusted figure amounted to -10.8% y/y) accompanied by some one-off factors as higher auto sales connected with scrapping bonus offered by the German government to new car buyers. Higher growth rate may be also connected to a rebound of sharp drops in capital goods purchases (machinery, transport equipment). The trend in business activity remains negative. Many sectors still suffer from over-investment and we are unlikely to see a rebound soon. We thus expect double digit drops in industrial output to come back in coming months.

As for the good news connected to industrial output data, we saw a stabilization of producer prices which grew in March by 0.1% on monthly basis bringing the annual growth rate to 5.6% after 5.7% a month ago.
The data confirm the ongoing process of disinflation. After the period of substantial rises in manufacturing prices, they remained at last month's level despite an earlier spike in energy costs and weaker currency. Growing spare capacities, lower growth rate of labour costs and moderation in FX market should help producer prices to stabilize on monthly basis (which translates into falls of the annual figure) or even record outright declines, in accordance with business tendency indicators.

As for the MPC decision, we abstain from final judgments until (possibly much weaker) data on retail sales see the light. The hawkish camp remains strong whereas better data on production made some stir on the dovish side. That is why we think it is wiser to bet on a reductions in repo rate within next couple of months, when ongoing weakness in the economy and falling inflation will make MPC cut further to 3-3.25%.

MID-TERM FORECATS

Indicator	2006	2007	2008	2009	2010
GDP y/y (%)	6.1	6.5	4.8	0.0	2.0
Inflation rate (%, average)	1.0	2.4	4.3	3.0	2.0
Current account (% of GDP, average)	-2.1	-4.5	-5.3	-3	-2.5
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	3.25	4.00

Indicator	2008		2009			
	Q3	Q4	Q1	Q2	Q3	Q4
GDP y/y (%)	4.7	2.9	1.0	-1.0	-1.5	0.4
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	3.25	3.25	3.25

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

Fixed Income

One big surprise - negative.

Last week the biggest even on the market was publication of the public deficit figure. While market expectations were anchored at around 2.7% the release came much higher than expected standing at 3.9% quite far away from Maastricht criteria (worse than Hungary figure even). While one may say that this is historical data it is worth looking what consequences it may bear for the future. And it doesn't look good at all. For this year public deficit will be even higher, probably above 4.5% putting question mark on ERM2 entry either this year or even 2010. Poland will be also under no doubt under excessive deficit procedure. In fact this means that Poland is currently and will be for sometime fulfilling NONE of the Maastricht criteria. As it was huge negative surprise for us, we decided to close all our receive positions past 2y, we also think that curve can start to go steeper from current levels. As far as our short position in 3x6 we are close to the stop loss. Nevertheless we think that levels above 4% are almost free option to receive. We still see most value in holding 2y bonds.

RECOMMENDATION:

Close long duration trade, risk of the steeper curve especially in the 5y10y area.

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.242%	3/30/2009
52 Week T-bills	4/28/2009	-	4.840%	4/20/2009
2Y T-bond OK0711	5/6/2009	-	5.615%	4/1/2009
5Y T-bond PS0414	5/6/2009	-	6.039%	4/1/2009
10Y T-bond DS1019	5/13/2009	-	6.224%	4/8/2009
20Y T-bond WS0429	5/13/2009	-	5.369%	1/14/2009

Money Market

Liquidity heading to the deposit arte level

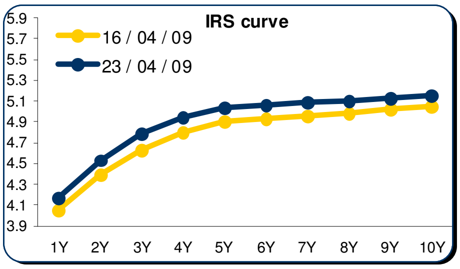
Real economy argument for hawks this month

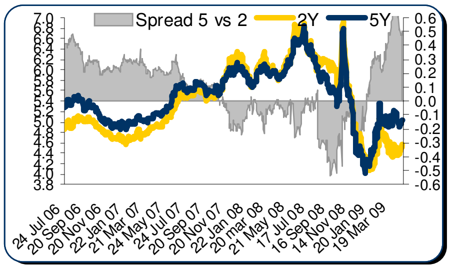
Liquidity still boosted and the shortest rates are heading to the deposit rate level, as we are approaching the end of the current reserve requirement settlement period. Therefore, the possibility of the rebound is next to nothing. Some figures were surprising but without any significant impact on the market. Wages 5.7% vs. 4.1% expected, Industrial output -2% against -9% expected. Both are arguments for the hawkish wing of the MPC. Nonetheless we still see the probability of another cut in April at 60%. The new information that showed up is the problem with the budget deficit. Very important factor, we are a bit surprise with the lack of the appropriate market response.

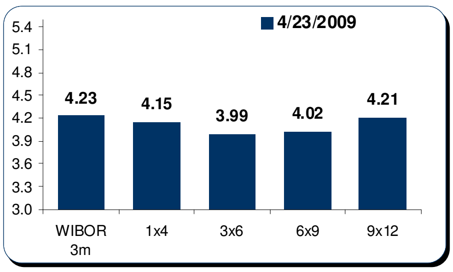
RECOMMENDATION:

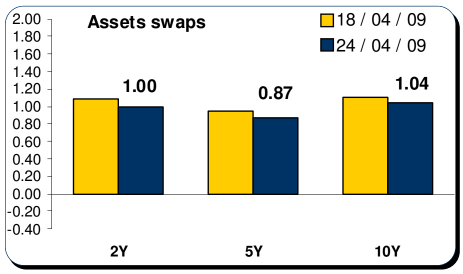
Pay 1Y polonia at current levels.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty Weaker

Bad news for Poland, 2008 deficit was verified from 2.7% of the GDP to 3.7 %. It is grim information for the fast EUR accession, it had no immediate effect but it has shaded the investment picture. After breaking the resistance for EUR/PLN at 4.3500 we are quickly approaching 4.5000.

Volatility higher

With softer zloty, the implied volatility has picked up. The EUR/PLN front end of the curve is back well above 20. The 6 month were paid at 19 % and 1 y was paid at 18.5 %. The liquidity is improving and we have seen healthy two way interest which has caused the spreads narrowing. But don t be fooled by that, if the spot EUR/PLN will trade above 4.5500 the panic will be back on the market.

RECOMMENDATION:

SPOT

Stay aside/ Sell at higher levels

Main supports / resistances:
EUR/PLN: 4.3850 / 4.5800
USD/PLN: 3.3500 / 3.5000

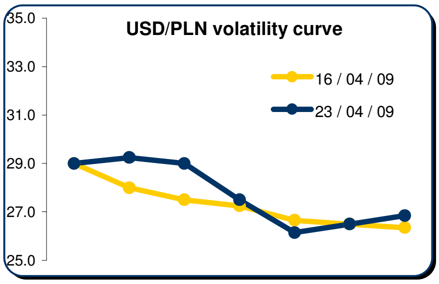
Brake of 4.3500 has triggered the swift move to 4.4600. In our eyes It is the correction in the uptrend of the zloty. We have to allow the test of 4.5500 or even 4.6500, the levels that we expect to hold. But till then we will not play against the market.

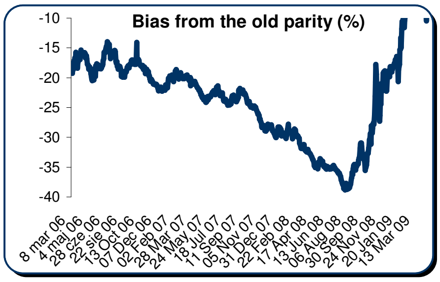
Sell spikes

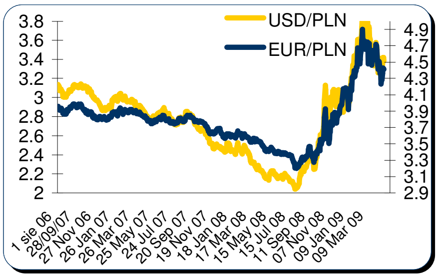
OPTIONS

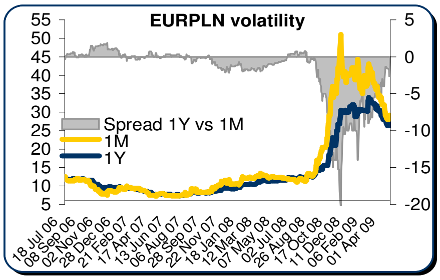
We fundamentally believe in the short Vega position. After the partial profit taking we are eager to sell front end of the curve above 30% and for the back end above 20 %

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
17/04/09	4.13%	4.19%	4.17%	6.49%	4.22%	6.59%
20/04/09	4.05%	4.21%	4.23%	4.23%	4.25%	4.27%
21/04/09	4.10%	4.22%	4.25%	4.25%	4.30%	4.31%
22/04/09	4.05%	4.23%	4.22%	4.25%	4.30%	4.35%
23/04/09	4.05%	4.24%	4.25%	4.25%	4.30%	4.38%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
17/04/09	4.01%	3.76%	3.77%	4.00%	3.97%
20/04/09	3.99%	3.80%	3.86%	4.01%	3.99%
21/04/09	3.98%	3.82%	3.82%	4.00%	3.96%
22/04/09	4.02%	3.83%	3.85%	4.01%	4.00%
23/04/09	4.05%	3.92%	3.94%	4.10%	4.03%

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
17/04/09	6.59%	4.84%	4.39%	5.47%	4.91%	5.85%	5.04%	6.15%
20/04/09	4.27%	4.85%	4.47%	5.51%	4.95%	5.88%	5.08%	6.16%
21/04/09	4.31%	4.85%	4.49%	5.48%	4.96%	5.86%	5.09%	6.16%
22/04/09	4.35%	4.80%	4.56%	5.53%	5.04%	5.90%	5.15%	6.19%
23/04/09	4.38%	4.80%	4.53%	5.53%	5.04%	5.90%	5.15%	6.19%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/04/20	10/04/20	95.337	4.84%	1500	3239	1492
OK0711	09/04/01	11/07/26	88.147	5.62%	2000	4384	2144
PS0414	09/04/01	14/04/26	98.748	6.04%	1500	2427	1514
DS1017	09/04/08	19/10/25	94.460	6.22%	2500	4846	1820

FX VOLATILITY

	USD/PLN 0-delta stradle				25-delta RR		25-delta FLY	
date	1M	3M	6M	1Y	1M	1Y	1M	1Y
17/04/09	28.00	27.25	26.65	26.35	5.50	6.75	1.40	1.40
20/04/09	28.00	27.25	26.65	26.35	5.50	6.75	1.40	1.40
21/04/09	28.00	27.25	26.65	26.35	5.50	6.75	1.40	1.40
22/04/09	29.00	27.25	26.65	26.35	5.50	6.75	1.40	1.40
23/04/09	29.25	27.50	26.15	26.85	5.50	6.75	1.40	1.40

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
17/04/09	3.2764	4.2848	-9.49%
20/04/09	3.3600	4.3592	-10.48%
21/04/09	3.4196	4.4289	-7.95%
22/04/09	3.4205	4.4212	-7.66%
23/04/09	3.3862	4.4147	-9.27%

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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