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FINANCIAL MARKETS DEPARTMENT

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POLAND WEEKLY REVIEW

MACROECONOMICS AND FINANCIAL MARKETS

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PREVIEW: The week of June 19th to June 25th

Indicator	Date of release	Period	BRE forecast	Consensus	Last	Comment
Industrial output y/y	Jun 19	May	**-5.2%**	-6.9%	-12.4%	No difference in working days on annual basis. Better business tendency indicators (including PMI); low basis from 2008.
Producer Prices y/y	Jun 19	May	**4.5%**	4.5%	5.1%	EUR/PLN relatively stable. Rising oil prices offset by falling USDPLN. High basis from 2008 compared with further drops of prices (business tendency indicators) expected by firms.
MPC decision	Jun 24	-	**3.5%**	3.5%	3.75%	Faster falling inflation and relatively and softer GDP projection (inflation projection may be quite elevated in short-term, although consistent with MPC target in medium term) are among the main reasons behind the cut.
Retail sales	Jun 25	May	**-1.0%**	0.8%	1.0%	Rather disappointing data on car sales and possible correction of food sales (after the Easter period). Low purchases of durable goods.

In Focus / Macroeconomics

Fresh package of macroeconomic data

This week brought some figures which may comfort MPC on the way of further monetary policy easing. We confirm our view that the data described below and the inflation projection (seemingly quite conservative on inflation but confirming sharp fall in economic activity) are enough to trigger another rate cut to 3.5% in the coming meeting.

The publications started with CPI which fell in May to 3.6% from 4.0% in April, meeting our expectations. Although it is hard to single out one factor contributing to the moderation, we witnessed quite benign behavior of food prices (+0.7% m/m) and predictable growth of fuels (+2.6%). Apart from seasonal factors, there was a moderate growth in core categories raising annual core inflation rate to 2.7% from 2.6% in April. We expect both measures of inflation to moderate in coming months. CPI inflation is likely to fall to 3.1-3.2% on seasonal drop of food prices, accompanied by a modest regulated price cuts (gas). As for the longer perspective, substantial output gap, benign behavior of wages, FX stabilization (appreciation) are likely to bring inflation back to 2.5-3.0% in the year end. Strong base effects from early 2009 are likely to damp inflation severely in 2010 towards 1.5% on average (the today announced MinFin forecast is even more optimistic at 1.0%).

Two days after, C/A balance hit +171mln EUR in April after +75mln recorded a month ago. The improvement stems from better trade balance (+28mln EUR vs -77mln EUR a month ago), positive current transfers account (+610 mln EUR on substantial EU inflow), positive services account (+249mln EUR on softer demand on foreign-rendered services, mainly transport) and negative income account (-716mln EUR). The data confirm that weakening zloty and soft consumer sentiment encourage buyers to substitute foreign goods for the domestic ones (hence a massive fall of imports reaching 37% y/y). We still think that owing to higher price competitiveness of Polish goods (depreciated zloty) and quite bright perspectives on domestic prices (Eurostat quoted yesterday that Poland enjoys the most moderate growth of hourly labor costs among regional peers which was partially confirmed by the drop of wages) are likely to spin Polish exports as soon as western economies recover. That is why we expect the trade balance to remain a solid contributor to current account balance and to GDP growth in 2009 as well. We estimate the C/A deficit to GDP ratio to fall towards 2-3% at the end of the year, minimizing the risk of Polish foreign position financing.

The growth rate of wages decelerated sharply in May to 3.8% from 4.8% a month earlier (a way from market consensus at 5.0%). The outcome is consistent with ailing economy and confirms falling trend on wages, which we expect to grow by 2-3% y/y on average in the coming months. Softening growth rate of wages confirms the disinflation regime the Polish economy is in right now and should comfort MPC as far as demand-pull inflation is concerned. As for the growth rate of employment, it softened in-line with expectations to -1.7% y/y in May after -1.4% in April. The pace of lay-offs is likely to be sustained in the coming months. However, sharp contraction of wages may imply that part of the cost-cutting process was delivered via wage cuts, which helped to save relatively high number of jobs (taking into consideration the phase of the cycle); this notion remains to be confirmed, though. One has to note that the relatively strong correlation between growth rate of wages and industrial output – that is why we place a downward risk on the latter figure (to be published on Friday) what additionally reinforces rate cut expectations.

Tax revenues still under water; 2010 budget macroeconomic assumptions confirmed pessimistic

Budget revenues till May amounted to 111.05 bln PLN (36.6% of a target) and expenditures reached 127.4 billion PLN (39.7% of a target). Both realization of earnings and outlays is worse than expected.

Although an annual growth rate of revenues was negative yet in April, they finally showed some signs of improvement, rising 2.1% on annual basis after the first 5 months of the year. However, the advance in revenues stems mainly from higher absorption of EU funds (the progress of realization of those accelerated to 41.3% of the plan, compared with 23.8% a month before); indirect and direct taxes are still under water. On the expenditures side, expected savings have not been seen yet. In comparison with the same period of the last year, expenditure realization (versus the plan) is running 4pp. higher (39.7% vs. 35.8% last year).

According to the recent announcements, the Ministry of Finance is going to prepare a report on the economy and the budget in 2009 by June 23. It is going to form a basis for the amendment of the budget bill which, according to the recently announced plan, is going to be passed by the government on 7 July. According to our forecast, revenues in the whole year are likely to fall short of the plan by 30-40 bln PLN. Fresh comments by Mr Chlebowski (quite influential in Civic Platform) did not exclude raising value added tax for some goods and services or looking for savings in various agencies and funds (for example Agricultural Social Insurance Fund). As a result of earlier announced savings, transfer of some liabilities outside the central budget (totaling 20 billion PLN) and possible higher dividend extraction from state-controlled companies (it is hard to assess exact sum at the moment – recently confirmed plan sticks to 5 bln PLN in the whole year, 2 bln more than originally expected), budget deficit is likely to be amended towards 25-30 bln PLN, with the lower bound being more likely.

As for the fresh macroeconomic assumptions, Ministry of Finance expects GDP growth in 2010 at 0.5% and inflation rate on the level of 1.0%. Average employment in enterprise sector will decrease by 2.8% and unemployment rate is likely to reach 13.8% at the and of the year. Low GDP growth goes hand in hand with decelerating dynamics of wages. According to the Ministry, wages in the enterprise sector are likely to increase by 2.5% in nominal terms. These assumptions (just as we wrote in the last Weekly issue) are very conservative but, on the other hand, seem quite promising when it comes to the bargaining between various ministries and political factions. Conservative revenues forecast effectively prevents expenditures from being overly inflated (there is still an urging need for savings next year), leaving thereby a room for positive surprises next year should the pessimistic scenario does not come true (both GDP growth and CPI inflation may surprise to the upside).

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	12.8	13.5
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	0.8	-0.7	-1.1	0.5
Inflation rate (%, average)	4.7	3.8	3.2	3.1	2.5	2.4
NBP repo rate (end-of-quarter)	6.00	5.00	3.75	3.50	3.25	3.25

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

Fixed Income

Calm week on FI despite data and auction.

Last week was rather uneventful on the FI market. Despite lower CPI figure and rather positive switching auction rates stayed in a fairly stable range of 5 bp. Curve got a little bit steeper in 1y2y sector and 2y5y sector, bonds overperformed IRS market by far with 0711 leading the way. Next week we will have last piece of data and MPC decision. Our view is that MPC can cut rates on the back of new CPI projection and still rather unfavorable outlook for growth. As far as the positions we favor our long position in 0711, we start to like 5y IRS receive position as we start to differ a lot from market view about CPI path (our view is that CPI will be close to 2.5% at the end of the year and closing to 1.5% in the summer next year). We also maintain our view that domestic demand will be weak this year with exports leading the way to recovery (if such), which will additionally put downward pressure on prices. The main risk is that risk aversion will come-back which will push yield curve in the far end higher. We are neutral as far as budget deficit amendment, we don't see it as an issue observing demand for local bonds in recent months, and we think that it is already included in prices.

RECOMMENDATION:

Hold 0711 long, receive 5y at levels close to 5.60%

AUCTIONS

	next auc.	offer	avg yield last	last auction date
13 Week T-bills	-	-	6.142%	12/9/2008
26 Week T-bills	-	-	4.456%	5/4/2009
52 Week T-bills	6/22/2009	-	4.752%	6/15/2009
2Y T-bond OK0112	7/1/2009	-	5.456%	6/3/2009
5Y T-bond PS0414	7/1/2009	-	5.783%	6/3/2009
10Y T-bond DS1019	7/8/2009	-	6.340%	5/20/2009
20Y T-bond WS0429	7/8/2009	-	6.340%	5/20/2009

Money Market

Small demand for 6M repo

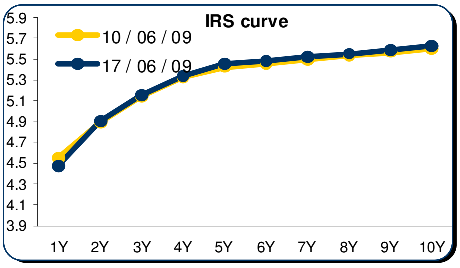
Better CPI triggered bull-ish sentiment

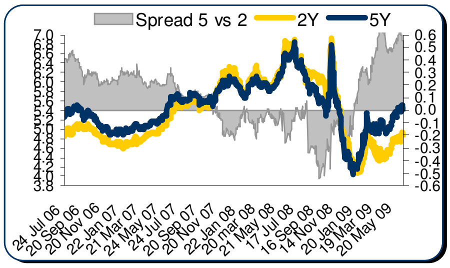
Another relatively cheap week for carry, therefore increasing probability for cheap end of the reserve. Lots of money bills in the system plus probability of the rates cut next week made the demand for 6M repo negligible. Only 750 million pln was repo out. Lower then expected CPI for May (3.6% vs 3.8% expected) triggered bullish sentiment. Market expects 25 bps cut plus the cheap end of the reserve, hence OIS curve dropped down by 25 bps (short terms) – 10 bps (longer terms). T-bills auction well bid, however average yield stayed at 4.75%.

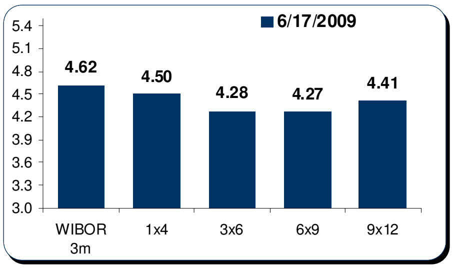
RECOMMENDATION:

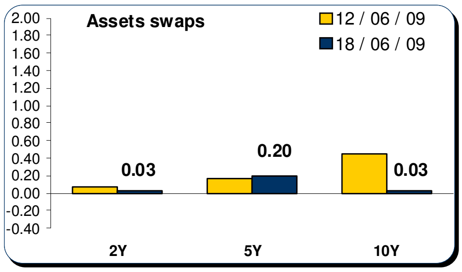
Sell short OISs 1W-1M.

FIXED INCOME & MONEY MARKET CHARTS









Foreign Exchange

Zloty weaker

This week zloty has opened at 4.4800 and weakened to 4.5630. Although weaker than in previous week, it is pretty same range since end of May.

Implied volatility lower

Trading underlying in range lowered curve a bit, 1M down to 18.0, and 1Y to 17.0.

RECOMMENDATION:

SPOT

Main supports / resistances:
EUR/PLN: 4.4300 / 4.6000
USD/PLN: 3.1000 / 3.3380

Sell upticks

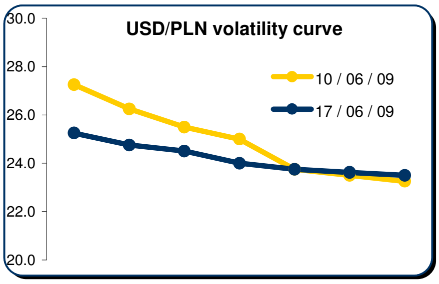
Relatively weak PLN is driven by regional bad sentiment (mainly Latvia budget problems) and anxiety of Polish budget amendment. We see potential losses up to 4.65/4.70. Because of good global sentiment we would sell there with target back to 4.45.

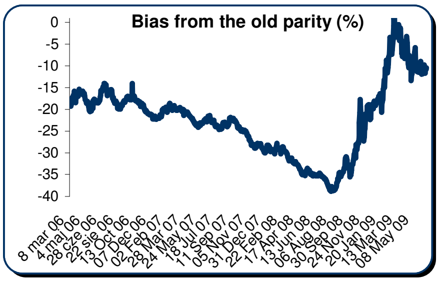
Sell vega on upticks

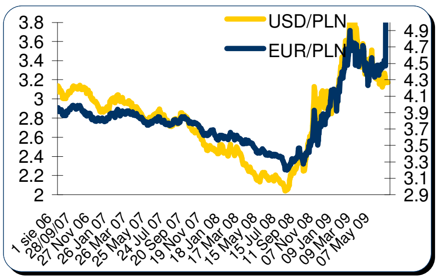
OPTIONS

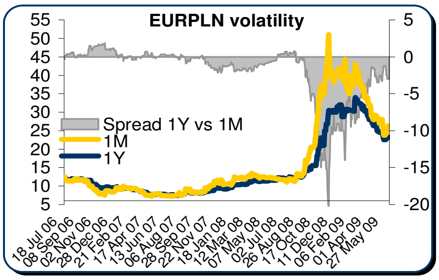
Vols looks a bit offered here, so we suggest wait for higher levels to entry short vega (20 vol for 1Y).
For hedging we suggest buying KO options as it is cheaper due to barrier pricing on high volatility market.
Exporters may have some benefits from selling Risk Reversals as it is nearly highs (5 vols favour call).

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
11/06/09	4.50%	4.62%	4.60%	4.66%	4.90%	4.94%
12/06/09	4.48%	#ARG!	4.60%	4.65%	4.90%	6.59%
15/06/09	4.48%	4.63%	4.61%	6.49%	4.92%	4.95%
16/06/09	4.47%	4.62%	4.75%	4.66%	4.95%	4.94%
17/06/09	4.47%	4.62%	4.63%	4.66%	4.89%	4.93%

FRA MARKET RATES

FRA Market Rates (Closing mid-market levels)

date	1X4	3X6	6X9	9X12	6X12
11/06/09	4.55%	4.41%	4.40%	4.52%	4.55%
12/06/09	4.52%	4.38%	4.35%	4.46%	4.50%
15/06/09	4.53%	4.38%	4.35%	4.47%	4.51%
16/06/09	4.53%	4.37%	4.35%	4.46%	4.51%
17/06/09	4.55%	4.39%	4.37%	4.49%	4.53%

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
11/06/09	4.94%	5.01%	4.89%	5.02%	5.42%	5.65%	5.60%	6.06%
12/06/09	6.59%	5.00%	4.95%	5.02%	5.51%	5.67%	5.65%	6.10%
15/06/09	4.95%	4.83%	4.92%	4.96%	5.47%	5.67%	5.64%	5.67%
16/06/09	4.94%	4.94%	4.90%	4.93%	5.44%	5.66%	5.61%	5.66%
17/06/09	4.93%	4.88%	4.90%	4.93%	5.45%	5.65%	5.62%	5.65%

PRIMARY MARKET RATES

Last Primary Market Rates

	au. date	maturity	avg price	avg yield	supply	demand	sold
52W TB	09/06/01	10/06/01	95.305	4.87%	2000	9419	2125
OK0112	09/06/03	12/01/25	86.909	5.46%	4000	6658	4018
PS0414	09/06/03	14/04/26	99.835	5.78%	1000	1614	971
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
11/06/09	26.25	25.00	23.75	23.25	4.00	5.25	1.25	1.25
12/06/09	24.25	24.00	24.00	23.75	0.00	0.00	0.00	0.00
15/06/09	24.75	24.00	23.75	23.50	0.00	0.00	0.00	0.00
16/06/09	26.00	24.25	24.00	23.75	0.00	0.00	0.00	0.00
17/06/09	24.75	24.00	23.75	23.50	0.00	0.00	0.00	0.00

PLN SPOT PERFORMANCE

PLN spot performance

date	USD/PLN	EUR/PLN	bias
11/06/09	3.1698	4.4729	-9.82%
12/06/09	3.1698	5.4729	-10.86%
15/06/09	3.1698	6.4729	-11.67%
16/06/09	3.1698	7.4729	-10.58%
17/06/09	3.1698	8.4729	-10.84%

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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