



Financial Markets Review

12 February 2010

Bond yields rise on fears over sovereign debt levels

The euro's downward slide continued this week as Greece dominated market focus once again. The euro lost ground against all the G-10 currencies apart from the Japanese yen. It was a tale of two halves for GBP/EUR, falling for the first three days of the week before rallying sharply to end the week at 1.1497, up 0.17%. Sterling had a volatile week, but ended a touch lower versus the USD following a dovish Quarterly Inflation Report (QIR) by the Bank of England.

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The SNB were also active once again, intervening twice this week by selling Swiss francs and purchasing euros when EUR/CHF was trading around the 1.4640 level. Interventions, however, appear to be having impacts of smaller magnitude each time.

Emerging market currencies also performed well over the week with the Colombian Peso the top performer, gaining 3.6% versus the US dollar while the Chilean Peso (+1.87%), South Korean Won (+1.57%) and Polish Zloty (+1.52%) all posted robust returns.

Financial market review - foreign exchange

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GBP/USD traded in 1.5550-1.5750 range this week, rallying to the highs of the week (1.5764) ahead of the QIR following much stronger than expected manufacturing output data and in anticipation of a hawkish report. In the event, the Bank of England's new projections showed GDP to be revised down while the central case for CPI inflation was to undershoot the 2% target in two years time. This was the case with both constant and market interest rates. The Bank of England have clearly left the door open for more asset purchases should they deem economic conditions warrant. Sterling promptly sold off down to 1.5572. With no economic data releases for the rest of the week, moves in sterling were driven by market sentiment surrounding the Greece outlook.

Greece, and the potential package to ease the debt burden, was the main focus of the week. Speculation that a plan would be announced by the EU kept the euro supported earlier in the week. The speculation was confirmed on Tuesday when EU officials stated that the EU had reached "an accord" on Greece. EUR/USD rallied up to 1.3837, the high for the week. Euro strength was short-lived however when clarity on what the deal may involve failed to materialise. More substantial details are expected to be unveiled next week following the EcoFin meeting. EUR/USD steadily sold off down to 1.3535 where short-covering into the weekend and protection of a large barrier option at 1.3500 led to a rally back up to 1.3600. The SNB were also active once again, intervening twice this week by selling Swiss francs and purchasing euros when EUR/CHF was trading around

Financial market rates, ending Fri. 12 Feb 2010

At 5pm, 12 Feb 10	Change from 5 Feb 10	
FTSE 100	5142.45	+1.61%
Exchange rates		
US\$/UK£	1.5669	+0.37%
Euro €/UK£	1.1497	+0.17%
Euro €/US\$	1.3629	+0.21%
Swaps - 5 year (mid)		
		basis points
UK pound	3.05	+3.0
US dollar	2.66	+7.0
Euro	2.52	+2.0
Bond yields - 10 year		
UK	4.04	+16.0
US	3.68	+11.0
Euro	3.19	+8.0

the 1.4640 level. Interventions, however, appear to be having impacts of smaller magnitude each time.

The US dollar sold off on Monday and Tuesday as financial markets initially responded well to the expected bailout of Greece. As equity market began to sell off heavily as the week went on and no further detail was announced, the dollar rallied to reach new highs for the week on Friday. Economic data were positive during the week with initial jobless claims falling to 440k from 483k last week. The labour market data was coupled with encouraging data on the consumer front with retail sales rising 0.5% in January while ex-auto sales were up 0.6%. The DXY US dollar index hit its highest level since July 2009 at 80.748 before coming off a touch to end the week at 80.336%

Emerging market currencies also performed well over the week with the Colombian Peso the top performer, gaining 3.6% versus the US dollar while the Chilean Peso (+1.87%), South Korean Won (+1.57%) and Polish Zloty (+1.52%) all posted robust returns. In China, the PBoC raised the reserve ratio requirement for banks by 50bps.

€/£ failed to break below 1.35



£/\$ holding above 1.55 for now



Interest rate market review - bonds, cash and swaps

The underperformance of gilts vs treasuries and bunds was striking, especially at the long end where a 16bp jump in 10y yields underlined the increased aversion for UK paper since the end of QE last week. UK swap spreads plunged into negative territory, with 10y spreads ending the week at -12bp.

2010 calendar of central bank meetings

European ECB (1.00%)

4 March, 8 April, 6 May, 10 June, 8 July

US FOMC (0-0.25%)

16 March, 28 April, 23 June

UK MPC (0.50%)

4 March, 8 April, 6 May, 10 June, 6 July

Rolling calendar of UK data releases and events

CPI inflation (16/02)

BoE MPC minutes (17/02)

Labour market stats (17/02)

Public finances (18/02)

M4 money supply (18/02)

Retail sales (19/02)

Q4 GDP (26/02)

Mortgage approvals (01/03)

PMI manufacturing (01/03)

Rolling calendar of US data releases and events

TIC capital flows (16/02)

Housing starts (17/02)

Industrial production (17/02)

FOMC minutes (17/02)

Producer prices (18/02)

Consumer prices (19/02)

Consumer conf (23/02)

New home sales (24/02)

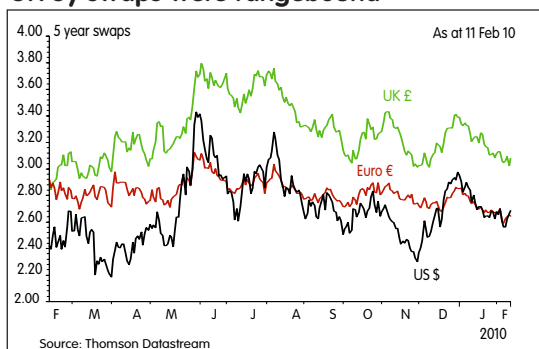
Durable goods order (25/02)

Worries about spiralling government deficits and below average participation at the US quarterly refunding were blamed for the rise in G3 government bond yields and steeper yield curves this week. The underperformance of gilts vs treasuries and bunds was striking, especially at the long end where a 16bp jump in 10y yields underlined the increased aversion for UK paper since the end of QE last week. The UK 10y yield spread over bunds widened to 85bp, the highest since August 2007. UK swap spreads plunged into negative territory, with 10y spreads ending the week at -12bp. UK 5y swaps were rangebound pretty much all week and finished 3bp higher at 3.05% after hitting a mid-week low of 2.99%. EU 2y yields fell below 1% after weak Q4 GDP data from Germany forced participants to rein in expectations of higher euro zone interest rates.

A dovish BoE Inflation Report triggered a sharp fall in gilt yields and swap rates on Wednesday as the Bank revised down its inflation forecasts for the next two years, based on unchanged Bank rate and on implied market rates. Governor King stressed that while no further stimulus had been announced, it is "far too soon to conclude" that no further asset purchases will be required. The Bank also scaled back its optimism for GDP growth next year and warned of the uncertainty for the year ahead. This briefly boosted the long end of the curve, with yields falling back a few bp in the 10-15y area. The 2y/10y swap spread widened though 230bps. Yields reversed sharply on Thursday and extended through 4% for 10y paper despite a fall in global equities. Rising concerns about spiralling public deficits in the developed economies and worries that investors could balk at tranches of new government debt without receiving a higher compensation dragged yields higher across the G3. Below average participation at the US 10y and 30y quarterly refunding also dampened enthusiasm for UK fixed income paper, with 30y gilts pushing through 4.55%. The two DMO auctions were well subscribed this week and attracted solid demand especially for the 2022 IL auction (2.42 bid/cover). The 2034 auction was covered 2.08 times.

Economic data had no major influence on markets

UK 5y swaps were rangebound



Kenneth Broux, Senior Market Economist
Altaz Dagher, Strategist

£/€ consolidating around 1.14

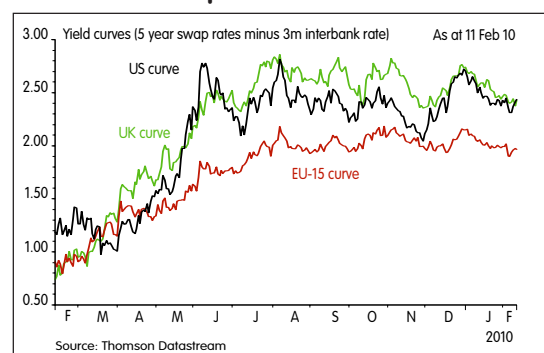


this week as participants paid close attention instead on the shaky state of equity markets and the crisis in the euro zone where the EU pledged its (political) support for Greece. An Ecofin meeting is scheduled next week where we should hear more clarity about the substance of a possible aid programme if confidence in Greek government debt evaporates. Bond markets expressed their reservation about the EU deal by pushing Greek spreads wider vs Germany on Friday from a mid-week low of 260bp back over 290bp.

The big surprise data wise in the euro zone was the flat outcome for German Q4-09 GDP vs expectations of a 0.2% rise. French GDP rose 0.6% q/q. The EU-16 aggregate figure came in at 0.1% q/q vs 0.3% forecast. This caused yields to drop sharply especially at the front end, where 2y yields fell below 1%. This effectively implies that the market no longer believes in higher euro zone interest rates before 2012. 5y swaps ended the week 2bp higher at 2.52%. The 2y/10y swap spread widened to 188bp.

Stronger than expected US economic data were overshadowed by Fed remarks over the central bank's exit strategy and below average participation at US 10y and 30y debt auctions. 10y yields climbed to 3.76%, a one-month high. US retail sales ex-cars rose a stronger than forecast 0.6% m/m in January, bolstering confidence that consumer spending will support economic recovery in early 2010. A larger than forecast drop in weekly claims to 440,000 from 483,000 added to upward pressure on yields. 5y swaps closed the week up 7bp at 2.66%.

Yield curves steepened



Foreign exchange - graphical analysis of recent trends

Chart 1: £/\$ holding at 1.56

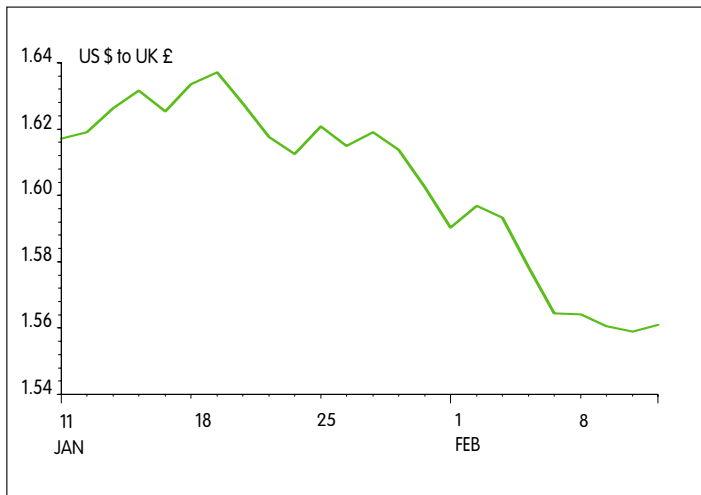


Chart 2: €/€ slides to 1.36

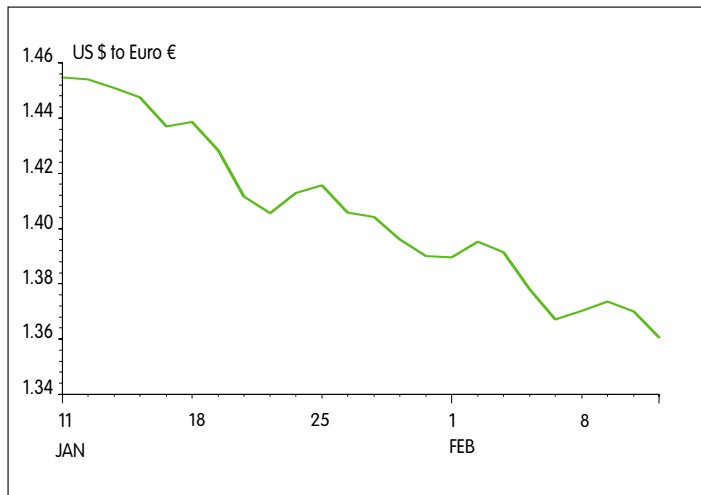


Chart 3: £/€ at upper end range

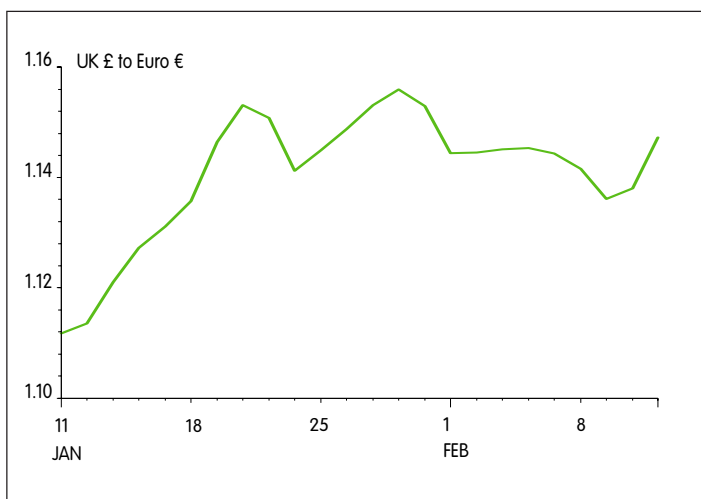


Chart 4: \$/¥ failed to break above 90

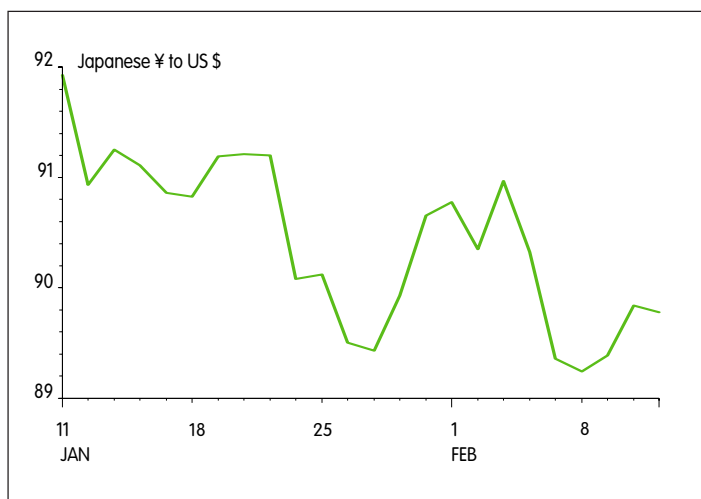
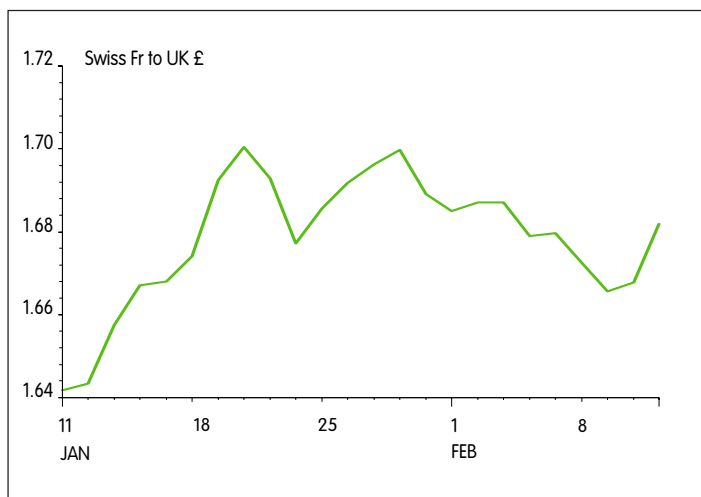


Chart 5: \$/C\$ back below 1.06



Chart 6: £/CHF pushed higher by SNB intervention



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Fixed income - graphical analysis of recent trends

Chart 1: UK 2yr yields rebound to 1.18%

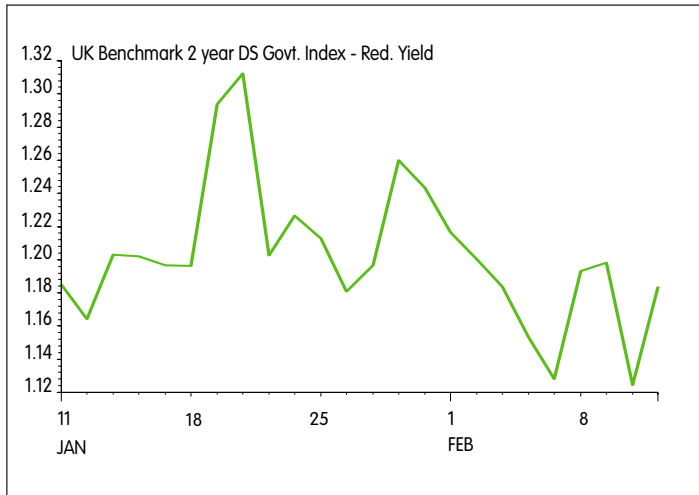


Chart 2: UK 10yr yield through resistance at 4.10%

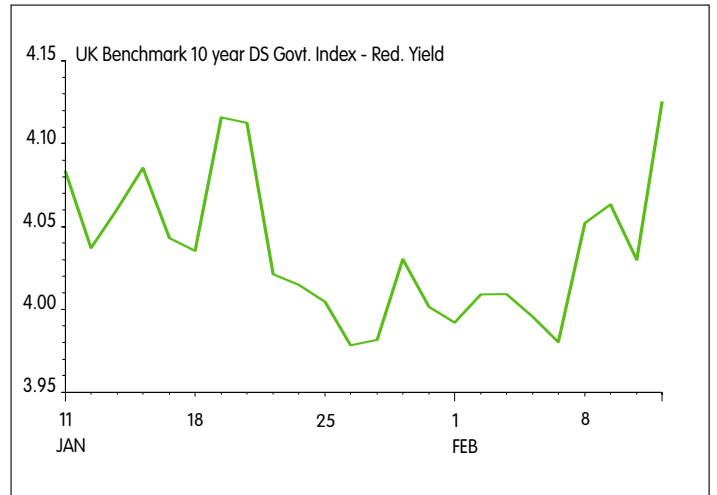


Chart 3: US 2yr yields eased back towards 0.85%

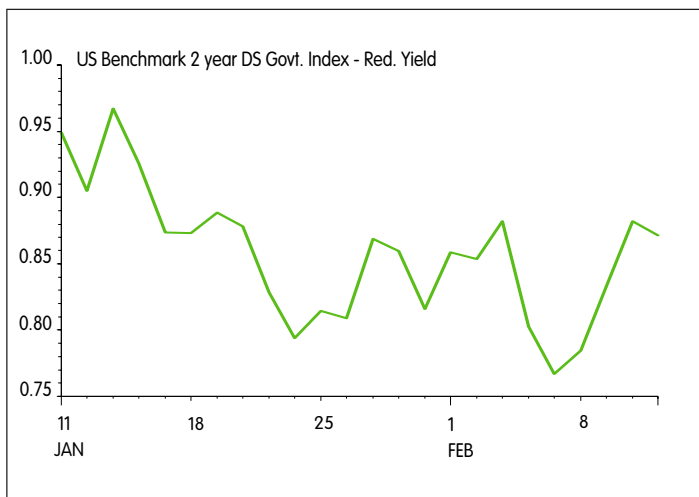


Chart 4: US 10yr yield rise to 3.70%

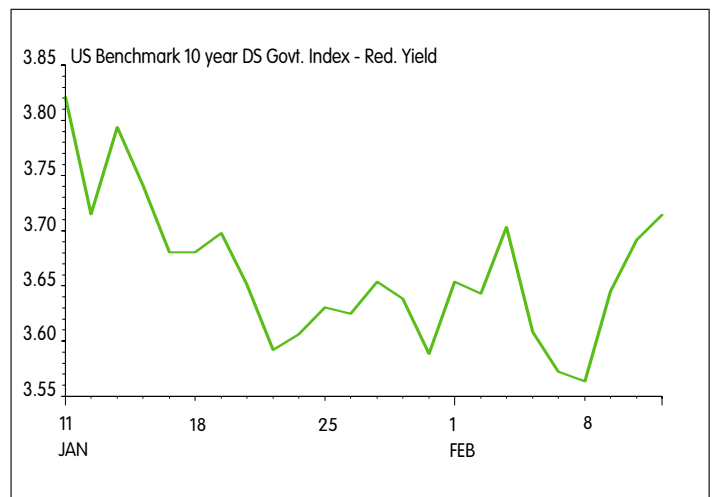


Chart 5: EU-16 2y yield bounces back over 1.00%

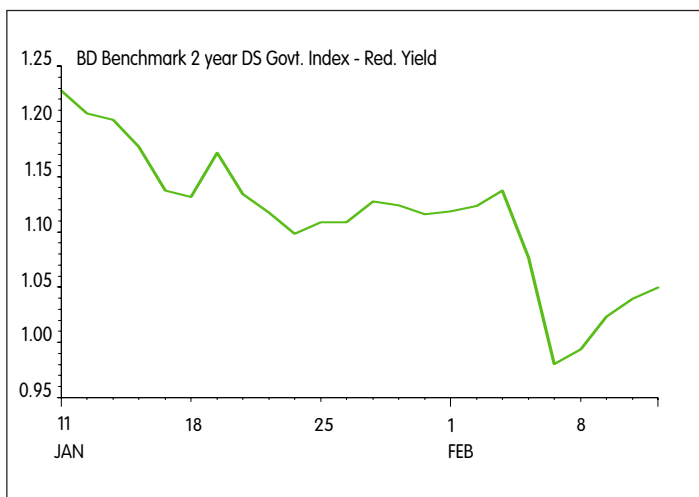
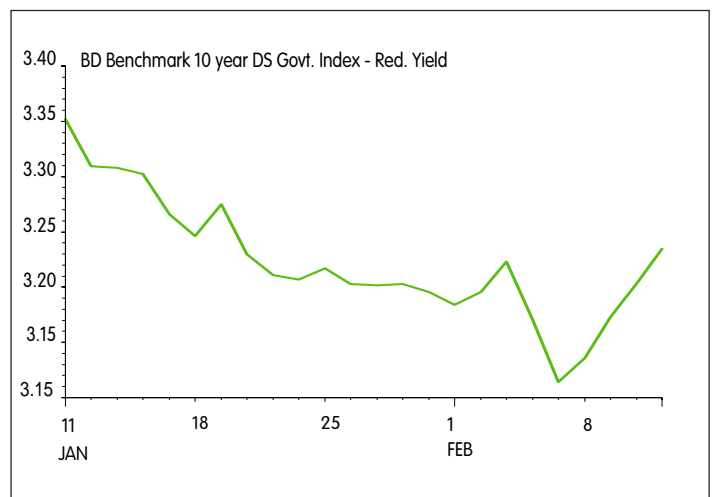


Chart 6: EU-16 10yr yields above 3.20%



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Interest rate markets - graphical analysis of recent trends

Chart 1: US 5yr swap bounces off lows



Chart 2: Euro 5yr swap



Chart 3: UK 5yr swap increases to 3.05%

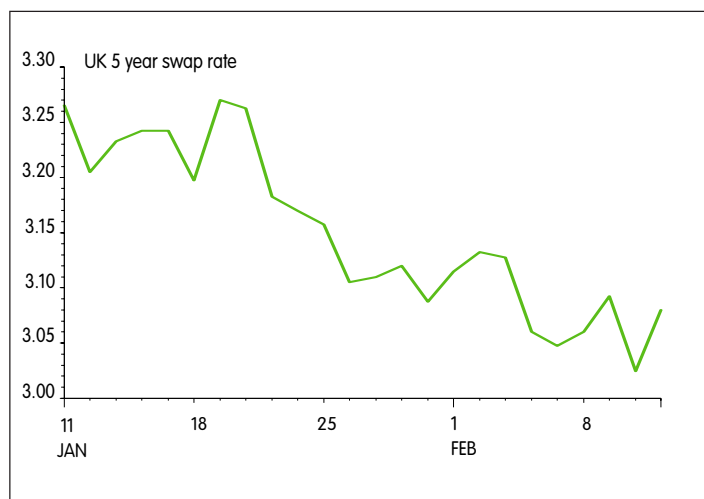


Chart 4: US curve steepened to 240bps

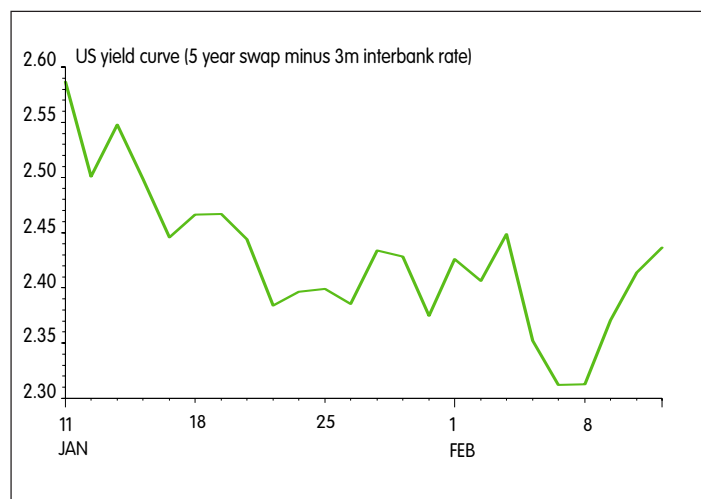


Chart 5: Eurozone curve spread heading back to 200bp

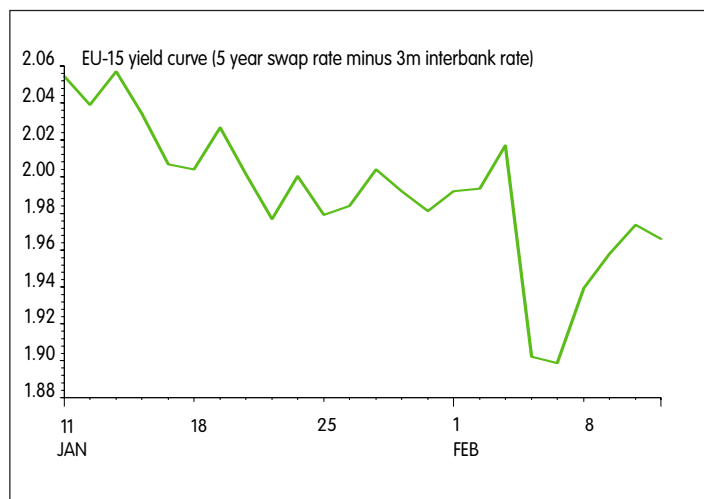
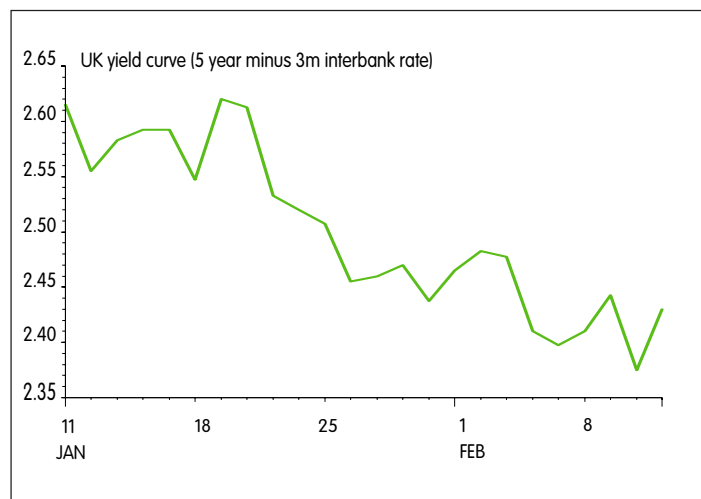


Chart 6: UK curve tests resistance at 240bps



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Key commodity and equity markets - Graphical analysis of recent trends

Chart 1: Gold back above \$1080

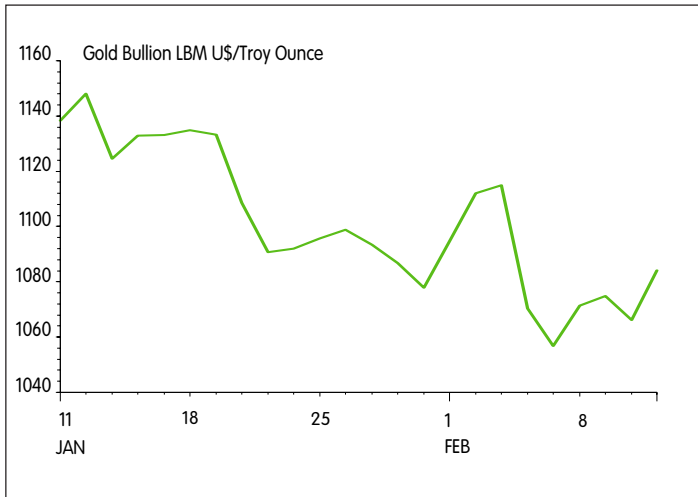


Chart 2: Brent crude bounced off support at \$70

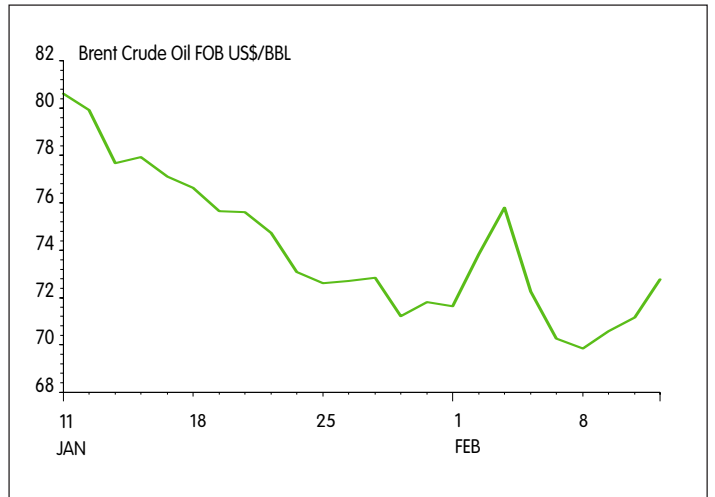


Chart 3: FTSE-100 approaching 5200

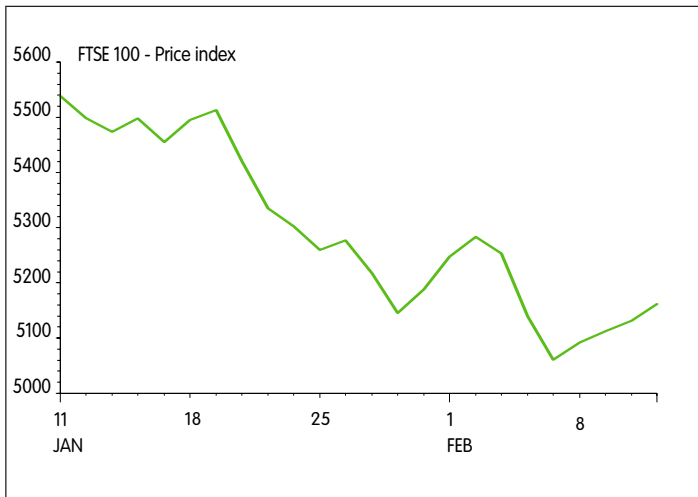


Chart 4: Dow Jones back above 10,000



Chart 5: Nikkei steady above 10,000

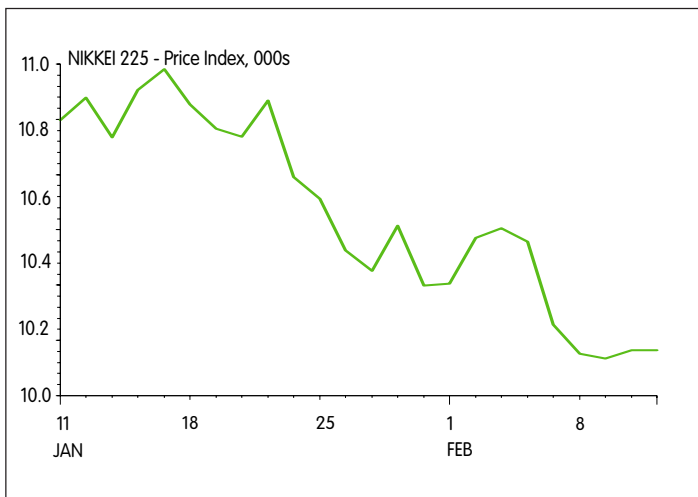


Chart 6: EuroFirst 300 heading back to 1000



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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