



## Financial Markets Review

12 June 2009

### Pound rallies on signs of UK recovery

The pound was buoyed by data this week suggesting the UK could emerge from recession as early as the current quarter. This saw £/\$ briefly rally though 1.66 and £/€ strengthen above 1.17.

In emerging markets, the Hungarian forint was the best performer this week against the US\$. In stark contrast, the Icelandic krona saw the biggest fall.

The Swedish krona rallied this week after the ECB agreed to lend the Riksbank €3bn to bolster its reserves to protect against any potential problems for its banking sector emanating from its high exposure to the Baltic region.

#### Financial market review - foreign exchange

The pound was buoyed by data this week suggesting the UK could emerge from recession as early as the current quarter. This saw £/\$ briefly rally though 1.66, before ending the week 3% higher at 1.6492. The pound also rose to a six-month high against the euro, £/€ gaining 2.8% to 1.1769 at the close of the week. The US\$ had another volatile week, but the dollar index rallied on Friday to close above 80. It still ended the week modestly weaker against the euro and yen, at 1.4014 and 98.30 respectively. Further broad gains for commodity prices and equities this week, with crude oil breaking through \$72, saw most commodity-linked currencies extend recent gains. The Australian and New Zealand dollars were also boosted by positive economic data, leading them to rise through 0.82 and 0.64 respectively against the US\$. However, the Canadian dollar finally closed the week 0.4% lower against the US\$ after the central bank reiterated concerns about the pace of its recent rise. The Swedish krona rallied this week after the ECB agreed to lend the Riksbank €3bn to bolster its reserves to protect against any potential problems for its banking sector emanating from its high exposure to the Baltic region.

In emerging markets, the Hungarian forint was the best performer this week against the US\$, gaining 3.9% on rising confidence that Latvia may avoid devaluation and speculation that interest rates may remain unchanged at 9.5% for some time. In stark contrast, the Icelandic krona saw the biggest fall against the US\$ this week on rising speculation that the repo rate, currently at 12%, will be reduced further. The Indian rupee pared some of its recent gains on concerns that rising crude oil prices will push up import costs and widen the trade deficit.

Although a relatively quiet week for UK data, the first rise in industrial output in over a year and indications from the NIESR, a leading economics think tank, that the recession may have ended, underpinned a solid week for the pound. Industrial output rose by 0.3% in

#### €/£ closed the week above 1.400



#### Financial market rates, ending Fri. 12 June 2009

| At 4.30pm 12 Jun 09          |         | Change from 5 Jun 09<br>% change |
|------------------------------|---------|----------------------------------|
| <b>FTSE 100</b>              | 4441.95 | +0.07%                           |
| <b>Exchange rates</b>        |         |                                  |
| US\$/UK£                     | 1.6492  | +3.00%                           |
| Euro €/UK£                   | 1.1769  | +2.83%                           |
| US\$/Euro €                  | 1.4014  | +0.16%                           |
| <b>Swaps - 5 year (mid)</b>  |         |                                  |
|                              |         | <b>basis points</b>              |
| UK pound                     | 3.76    | +15.00                           |
| US dollar                    | 3.28    | -3.00                            |
| Euro                         | 3.08    | -2.00                            |
| <b>Bond yields - 10 year</b> |         |                                  |
| UK                           | 3.98    | +6.00                            |
| US                           | 3.78    | -6.00                            |
| Euro                         | 3.64    | -8.00                            |

April, the first increase in fourteen months, with manufacturing output rising by 0.2%. The NIESR GDP estimate, a reliable predictor of the official data, showed the economy contracted by 0.9% in the quarter through May, up from a decline of 1.5% in the three months to April. Although clearly more erratic, monthly figures indicated output actually rose in April and May. However, BoE MPC speakers this week - Barker, Sentance and Fisher were all keen to warn against complacency and echoed that the economic outlook remained uncertain.

Rising bond yields and speculation that foreign central banks could diversify official reserves away from the US\$ kept downward pressure on the greenback this week. However, it staged a significant rally on Friday ahead of the G8 finance ministers' meeting, on concerns that the press statement may contain comments about the dollar. US economic data this week were overall supportive of the US\$, with retail sales rising for the first time in three months and the price-adjusted trade deficit in April coming in smaller than the average for the first quarter. Euro zone data this week showed a much sharper than expected contraction in industrial activity in April, notably contrasting with the more positive news from other economies.

#### £/\$ rallied through 1.66 this week



*Gilts under performed treasuries and bunds following stronger than expected UK economic data and a surprise increase in Q2 inflation expectations. 5y swaps rose above 3.70%.*

**Rolling calendar of UK data releases and events**

- Consumer credit (29/6)
- Mortgage approvals (29/6)
- GfK consumer conf (30/6)
- Q1 GDP (30/6)
- Manufacturing PMI (1/7)
- Services PMI (3/7)
- Industrial production (7/7)

**Rolling calendar of US data releases and events**

- Existing home sales (23/6)
- Durable goods (24/6)
- New home sales (24/6)
- Q1 GDP (25/6)
- Core PCE deflator (26/6)
- Chicago PMI (30/6)
- Consumer confidence (30/6)

**2009 calendar of central bank meetings**

- European ECB (1.00%)**  
2 July, 6 August, 3 September, 8 October
- US FOMC (0-0.25%)**  
24 June, 12 August, 23 September, 4 November
- UK MPC (0.50%)**  
9 July, 6 August, 10 September, 8 October

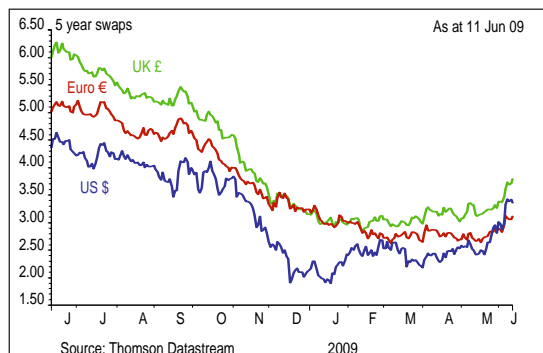
**Interest rate market review - bonds, cash and swaps**

The sell-off in government bonds peaked early in the week and yield subsequently drifted off the highs, supported by solid demand at US treasury auctions and speculation that the Fed could tweak its securities purchase program at the next FOMC meeting. Gilts under performed treasuries and bunds following stronger than expected UK economic data and a surprise increase in Q2 inflation expectations. Disappointing industrial output data in the euro zone and sharp falls in CPI helped bunds to recover some ground and long term yields to close lower on the week. UK 5y swaps touched a high of 3.87% but eventually settled on Friday at 3.64%. UK 3-month libor fell 1bp to 1.25%. The 3-month Libor/5y swaps curve steepened in the UK but flattened in the US and the euro zone.

Market participants rushed out of government bonds early on in the week on inflation fears and speculation that the US Fed will raise interest rates before year-end. In the week the dollar weakened and lifted crude oil prices above \$70pb. Confidence that the UK economy is on a recovery track accentuated the sell-off in gilts and squeezed 10y yields above 4% for the first time since November 21st last year. The 10y traded as high as 4.08% on Thursday, arguably driven by the NIESR report that the UK economy expanded in May. UK economic data on the whole surprised to the upside this week, including the RICS report of a 10-year high for house buyer enquiries in May and a first rise in industrial output in April in a year. The BoE Q2 Inflation Attitudes survey revealed a rise to 2.4% from 2.1% in inflation expectations for the 12 months ahead. This contributed to the upward squeeze in yields and to a switch from floating to fixed rates. Solid demand for gilt and longer duration treasury auctions eventually helped yields to stabilise and 5y swaps to fall back to 3.76% from the intra-week 3.87% high.

Action in treasuries was characterised by similar sharp increase in yields over the early part of the week and a subsequent pullback following strong demand on Thursday at the 30y auction. Concerns that rising US mortgage rates - the 30y fixed rate is up about 80bp since May - could delay the

**UK 5y swaps extend above 3.70%**



**Jeavon Loyal, Senior Economist**  
**Kenneth Broux, Economist**

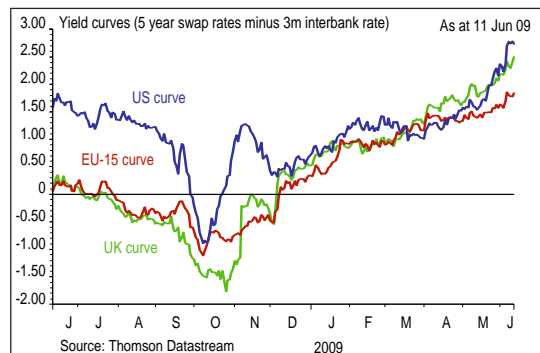
**£/€ neared 1.18 (1.1789) on Friday**



recovery in housing aided the late relief rally in treasury prices. The inability of equities to extend recent gains may also be credited for the pullback in yields especially in longer term maturities. The 30y auction on Thursday drew very solid overseas demand and calmed fears of selling of treasury holdings by some foreign countries, like Russia. Most US economic data releases met expectations. The trade deficit widened to \$29.2bn in April on lower exports. The 0.5% m/m gain in April headline retail sales was distorted by higher petrol sales. Weekly claims fell back to 601,000 but a rise in continuing claims reminded participants of the weak underlying labour market situation. 5y swaps fell back below 3.50% and closed the week down 3bp at 3.28%. No treasury auctions are scheduled next week. US 3-month libor fell 1bp to 0.62%.

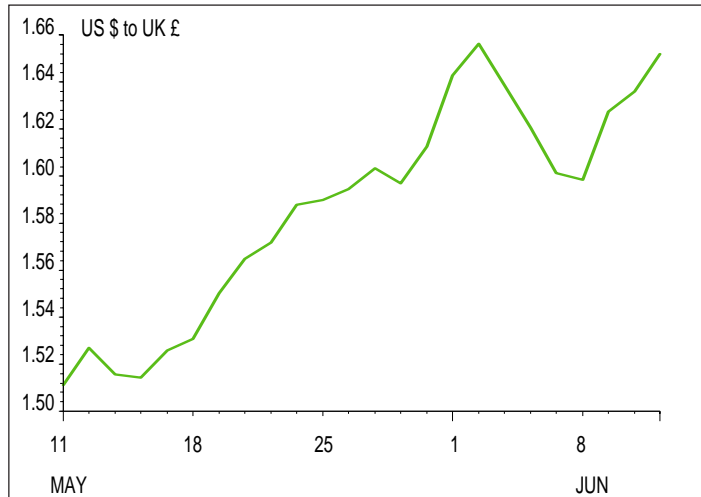
Shaper than expected falls in euro zone April industrial output and in German exports cast a cloud over recovery hopes for the euro zone economy and this contributed to a superior performance of bunds over gilts and treasuries. The long end also drew support from a steeper than expected fall in annual French CPI to -0.3% in April. With the ECB likely to keep interest rates on hold this year at 1%, the rise in 2y yields to 1.69% may be overdone. Regional spreads over bunds widened a couple of bps this week following dovish comments by a number of ECB speakers. 5y swaps fell back 2bp to 3.08%. Euro 3-month libor was unchanged at 1.27%.

**Yield curves steepened**

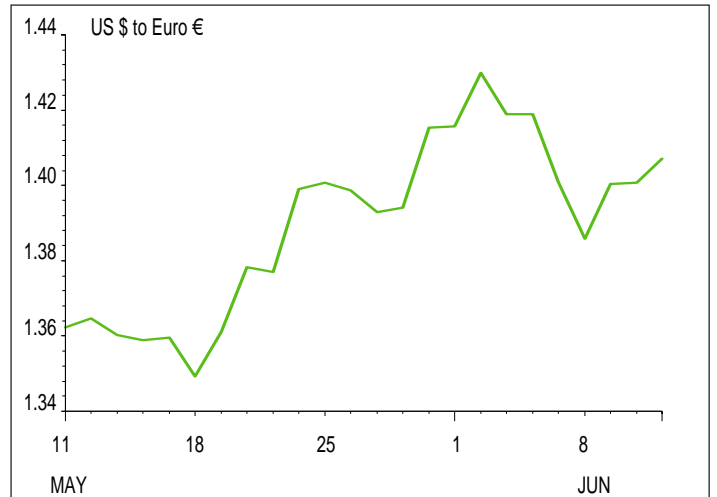


# Foreign exchange - graphical analysis of recent trends

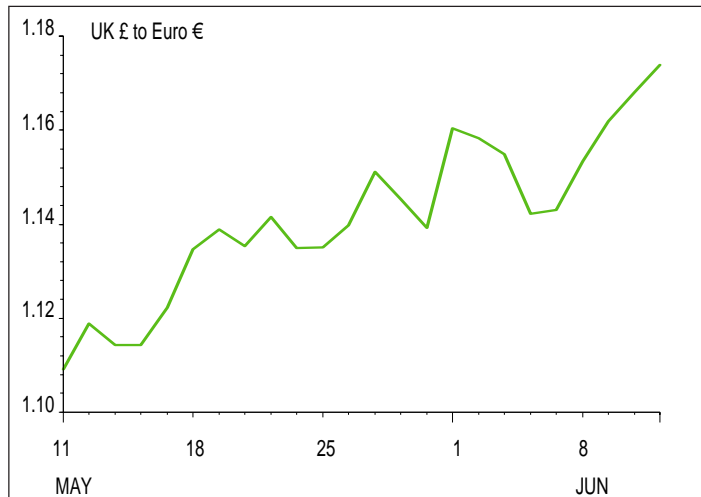
**Chart 1: £/\$ attracts demand above 1.60**



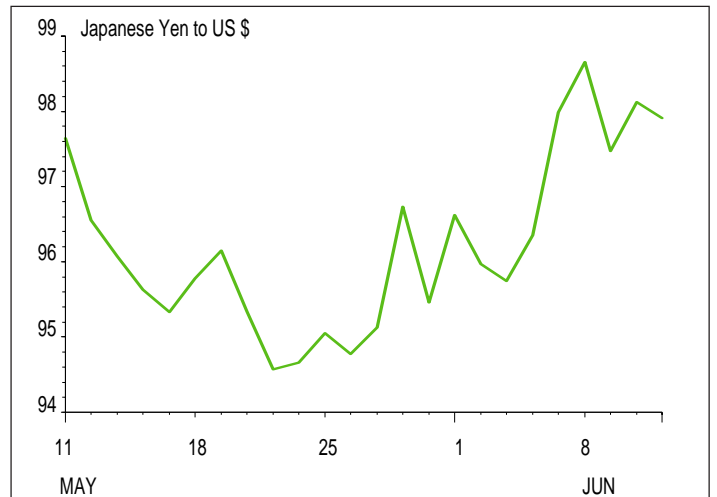
**Chart 2: €/€ supported around 1.40**



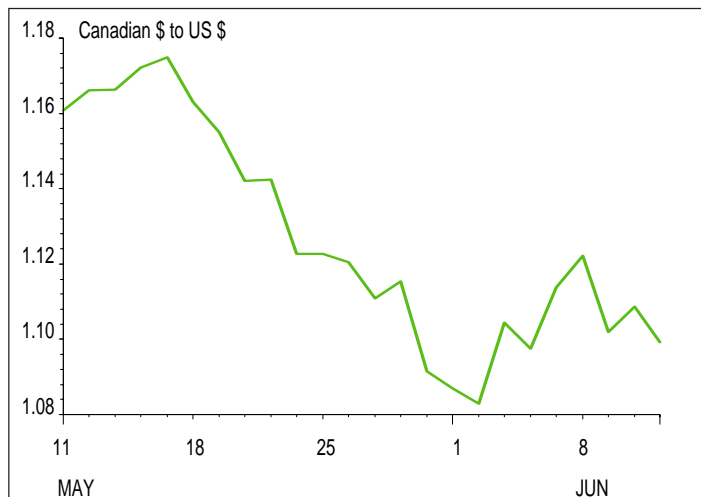
**Chart 3: £/€ rose above 1.17**



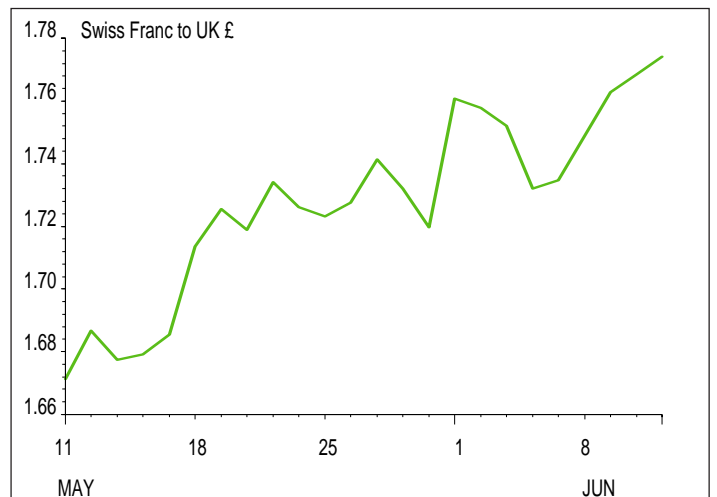
**Chart 4: ¥/\$ firmed above 98.0**



**Chart 5: \$/CS rebounded above 1.12**



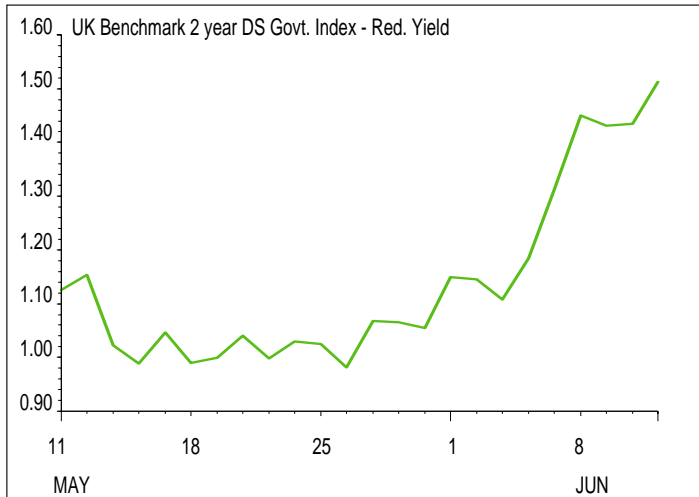
**Chart 6: The Swiss franc fell ahead of next week's SNB meeting**



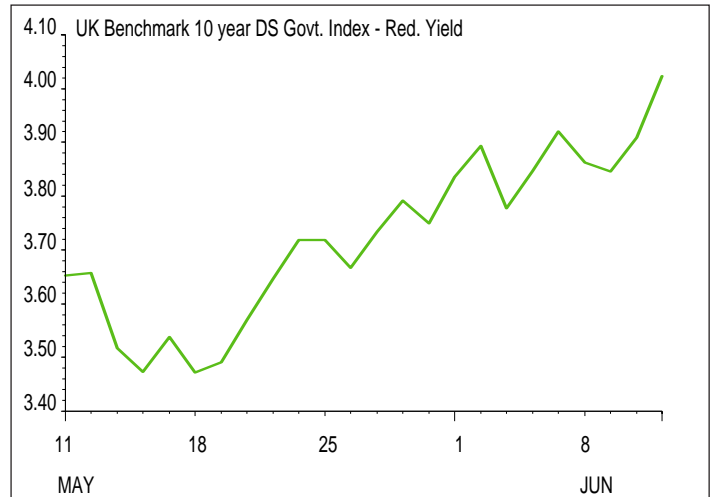
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Fixed income - graphical analysis of recent trends

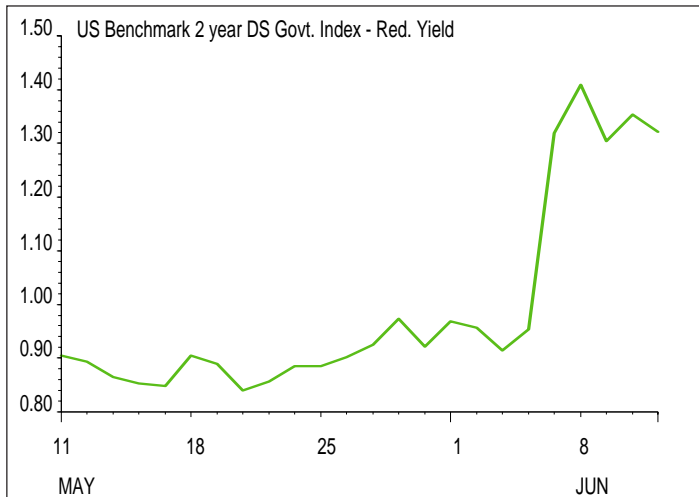
**Chart 1: UK 2yr yields hit 1.50%**



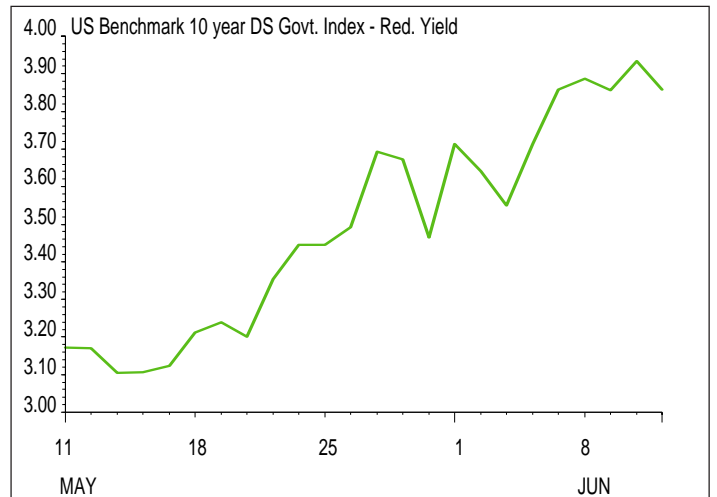
**Chart 2: UK 10yr yields cleared 4%**



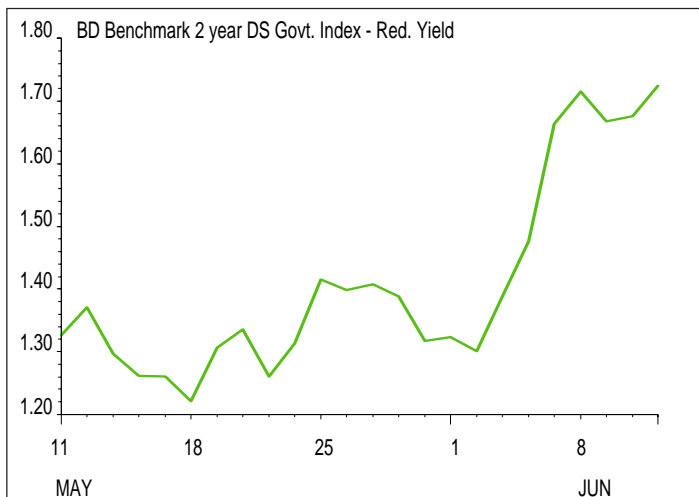
**Chart 3: US 2yr yields consolidated last week's gain**



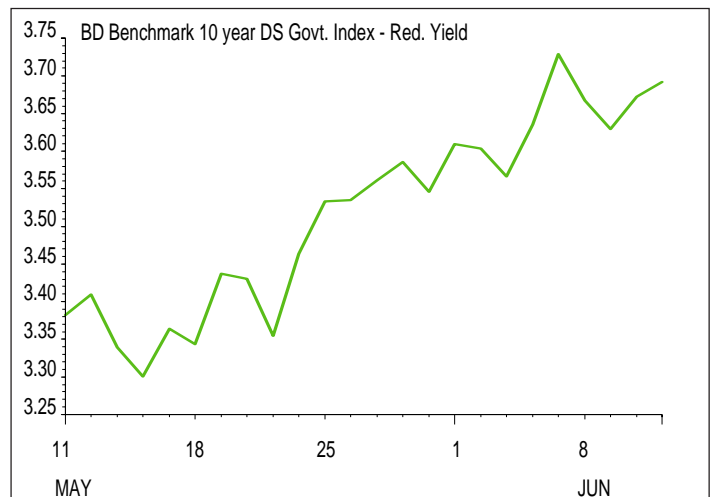
**Chart 4: US 10yr yields rose to 4%**



**Chart 5: EU-16 2yr yields touched 1.70%**



**Chart 6: EU-16 10yr yields find support above 3.60%**



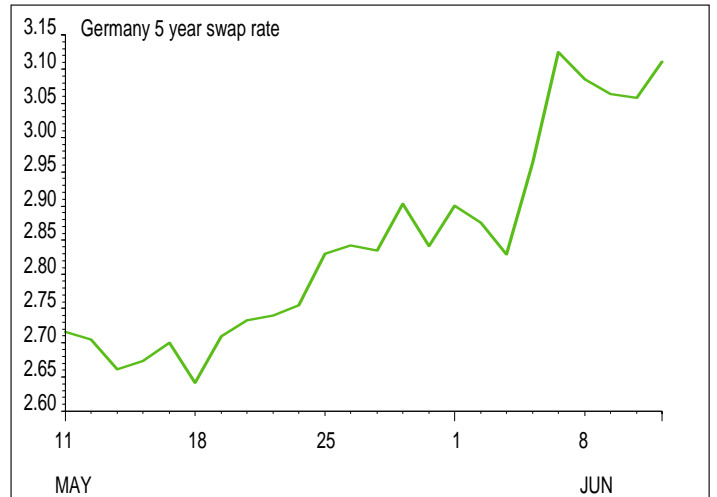
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Interest rate markets - graphical analysis of recent trends

**Chart 1: US 5yr swaps fell back below 3.40%**



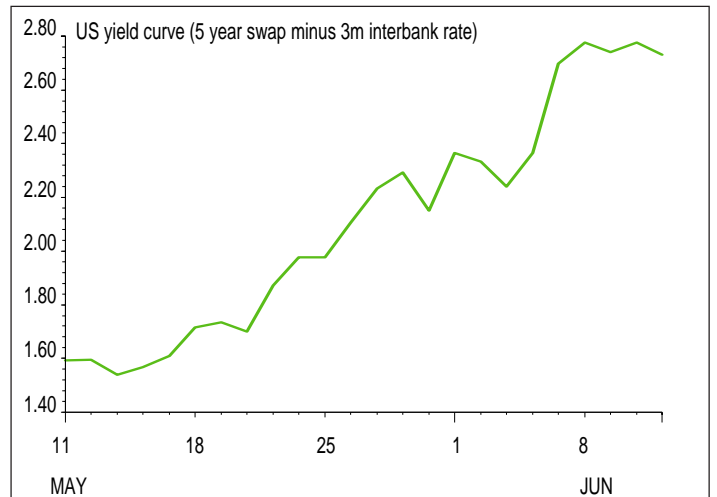
**Chart 2: Euro 5yr swaps steady above 3%**



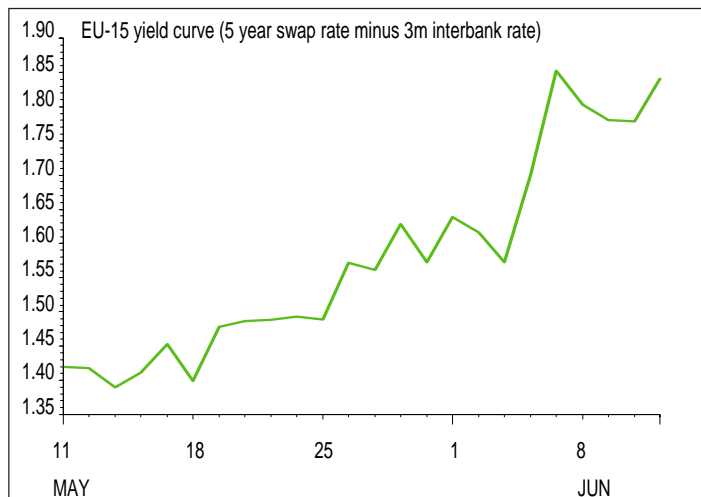
**Chart 3: UK 5yr swaps spike above 3.70%**



**Chart 4: US curve flattened on lower long term yields**



**Chart 5: Eurozone curve fairly stable**



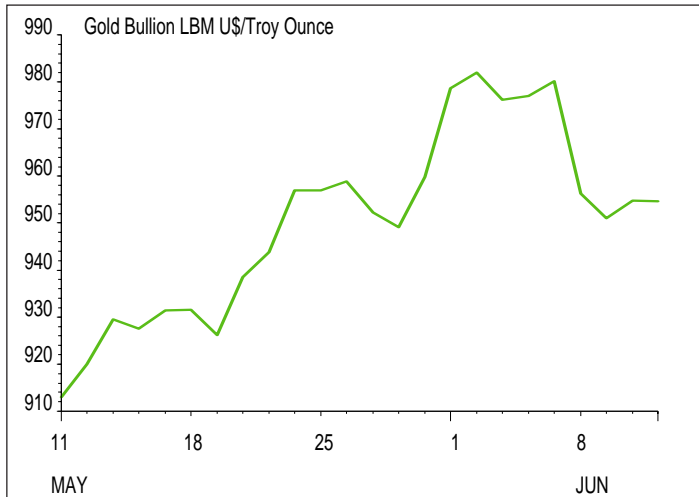
**Chart 6: UK curve spread widened**



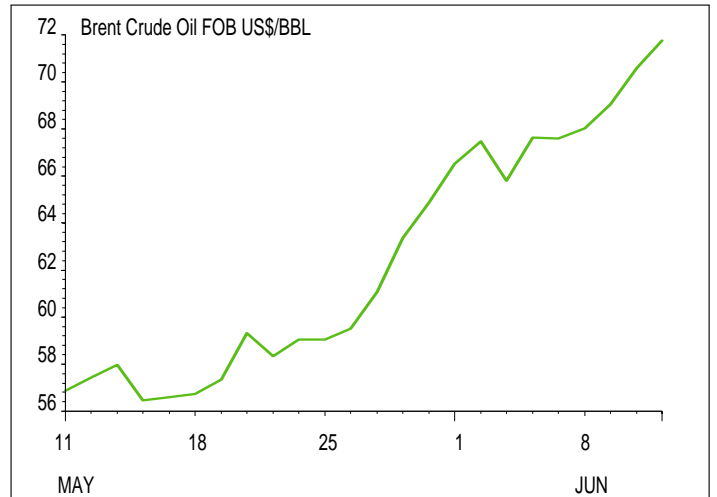
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Key commodity and equity markets - Graphical analysis of recent trends

**Chart 1: Gold fell below \$950**



**Chart 2: Oil prices rose above \$70pb**



**Chart 3: The FTSE-100 held above 4,400**



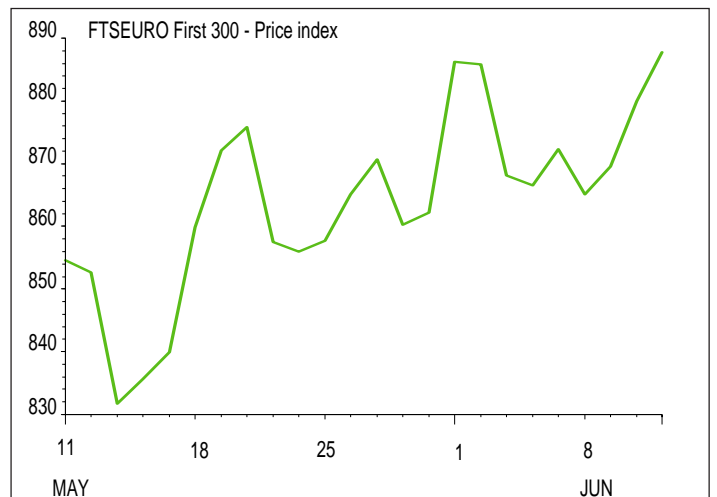
**Chart 4: The Dow Jones stayed within recent ranges**



**Chart 5: The Nikkei closed the week above 10,000**



**Chart 6: The FTSE EuroFirst 300: test of 900 target looms**



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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