



Financial Markets Review

21 November 2008

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Credit market tensions intensified this week

Credit market tensions intensified this week, pushing equities down sharply and buoying bonds, as investors looked for safe-havens

The Japanese yen was the best performing currency but the US\$ also fared well

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Financial market review - foreign exchange

Rising fears saw risk appetite retrench this week, pushing equities and benchmark bond yields to multi-year lows. The bearish sentiment was reflected in currency markets by another solid week for the yen, which rose to a 3-week high against the US\$ (93.57), in spite of data showing the Japanese economy in recession for the first time since 2001. In contrast, the biggest G10 fallers were the high yielding Australian and NZ dollars, prompting the RBA to intervene and purchase its own currency as it tested recent lows. Overall, the US\$ had another solid week, with the dollar index - its average value against six major world currencies, rising to the highest since April 2006 (88.46). Within this, £/\$ eased 0.3% on the week to 1.4784, while €/€ fell 1.4% to 1.2519. The SNB surprisingly cut its target rate by a record 1% this week, reducing it to just 1%, from 2.75% at the start of October. The franc fell to its lowest against the US\$ since August 2007 (1.2298), while €/CHF briefly rallied through 1.54. However, the biggest falls this week were again in emerging market currencies, led by the Brazilian real and Mexican peso, as risk aversion spiked up. It may in part have also reflected further selling pressure on commodities, with crude oil falling below \$50 for the first time since May 2005. However, gold prices rose for a third straight week.

Economic news in the UK this week confirmed the prospect of further interest rate cuts, however its impact on sterling was relatively limited. Inflation data showed consumer prices rose by 4.5% in the year to October, down sharply from 5.2% in September, with a large fall also in retail price inflation. We now believe that headline retail price inflation may be negative for 2009 as a whole, from 4.5% in October. The minutes of the Bank of England MPC meeting earlier this month provided another surprise, as they revealed that the committee considered cutting rates by more than the 1.5% sanctioned. This was based on projections in the Q4 Inflation Report that implied that a cut in excess of 2% might be required in

€/€ briefly broke below 1.2450 this week



Financial market rates, ending Fri. 21 Nov 2008

At 4.30pm 21 Nov 08	Change from 14 Nov 08 % change
FTSE 100 3780.96	-10.93%
Exchange rates	
US\$/UK£ 1.4784	-0.34%
Euro €/UK£ 1.1808	+1.08%
US\$/Euro € 1.2519	-1.42%
Swaps - 5 year (mid)	
UK pound 3.73	-23.8
US dollar 2.97	-41.8
Euro 3.53	-19.0
Bond yields - 10 year	
UK 3.85	-21.7
US 3.22	-49.5
Euro 3.38	-22.1

order to meet the inflation target in the medium-term. The comments raise the risk of a further cut next month, possibly by as much as 1%. Other UK data published this week showed retail sales were more resilient than expected in October, falling by just 0.1% during the month. Ahead of the Pre-Budget Report next week, public finances data showed borrowing already at £37bn in the first seven months of the fiscal year, compared with £20bn last October and the full year Budget 2008 target of £43bn.

A surprisingly sharp 1% fall in US consumer prices in October saw the \$ spike to its intra-week lows against the £ and € on Wednesday, at 1.5250 and 1.2814, respectively. However, the rallies proved short lived, as rising risk aversion saw the \$ strengthen at the close of the week. The \$ remained bid in spite of other data showing a sharp rise in initial jobless claims and some very disappointing housebuilding figures in October.

It was a relatively quiet week for data in the euro zone, however a busy one for ECB speakers. Their comments supported market speculation that further deep cuts in interest rates were likely in coming months. The main data highlight was the 'flash' services and manufacturing PMI estimates, which fell to record lows in October.

£/\$ failed to consolidate above 1.50



UK 2yr yields fell below 2.0% as speculation intensifies of more aggressive cuts in BoE base rate. The 10yr yield fell below 4.0%.

Very weak US economic data pushed the yield on the 3-month T-bill to just 0.03%. Fears of deflation pushed 10yr yield to 3.01%.

Rolling calendar of UK data releases and events

Mortgage approvals (1/12)
 PMI manufacturing (1/12)
 PMI services (3/12)
 Producer prices (8/12)
 Trade balance (9/12)
 Industrial production (9/12)
 Consumer prices (16/12)

Rolling calendar of US data releases and events

Manufacturing ISM (1/12)
 ADP employment (3/12)
 ISM services (3/12)
 Factory orders (4/12)
 Non-farm payrolls (5/12)
 Unemployment rate (5/12)
 Average earnings (5/12)

Central bank meetings in 2008-09

European ECB (3.25%)
 4 December, 15 January, 5 February, 5 March
US FOMC (1.00%) - 16 December, 28 January, 17 March, 29 April
UK MPC (3.00%) - 4 December, 8 January, 5 February, 5 March

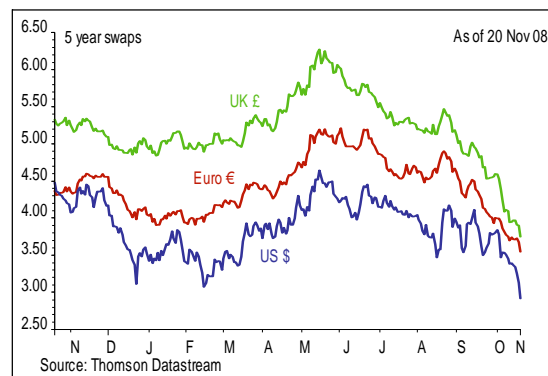
Interest rate market review - bonds, cash and swaps

A worsening backdrop for the global economy and the associated falls in equity markets kept intact the downward trend for G7 benchmark bond yields this week. Measures of credit risk widened appreciably as equities accumulated losses in the wake of negative business updates and announcements of job cuts by some of the world's leading companies. The grim outlook for the world economy and the fall in crude oil prices below \$50pb also caused deflation fears to intensify. This led to a generalised decline in yields in the US, the UK and the euro zone to historical lows. Yields on the US 10 and 30 yr bonds fell to a record low of 3.06% and 3.61%, respectively. The FTSE-100 closed the week down nearly 11%.

UK economic data was dominated this week by the report of a bigger than forecast drop in inflation in October. Both CPI and RPI inflation fell more than expected last month led by to sharp falls in oil prices and the cost of transport. Annual CPI fell to 4.5% from 5.2% in September and annual RPI fell to 4.2% from 5.0%. Core inflation slowed to 1.9% from 2.2%, the lowest since July. Sharp cuts in interest rates and falling house prices mean that we now expect RPI inflation to fall into negative territory next year. The rapid unwinding of inflation pressures and fears of outright deflation are putting downward pressure on long-dated yields, despite concerns that the Chancellor will announce a steep rise in government borrowing next week. The yield on the 10yr gilt fell to 3.85% this week, a drop of 22bps. The yield on the 30yr gilt fell 35bps to 4.06%. 5yr swaps ended the week down 24bps at 3.73%.

Speculation that the BoE will cut interest rates by 100bps to 2.0% in December was buttressed by the MPC minutes of the November meeting. These revealed that the BoE voted unanimously for the rate cut to 3.0% this month. We now expect the cost of borrowing will be trimmed next month to 2% as the BoE guards against inflation undershooting its 2% target next year. Retail sales figures for October were published on Thursday and showed a smaller than expected decline of 0.1% m/m. UK 3-month Libor fell 14bps this week to 4.04%, reducing the spread over Bank rate to 104bps, a 2-month low.

Swap rates fell sharply this week



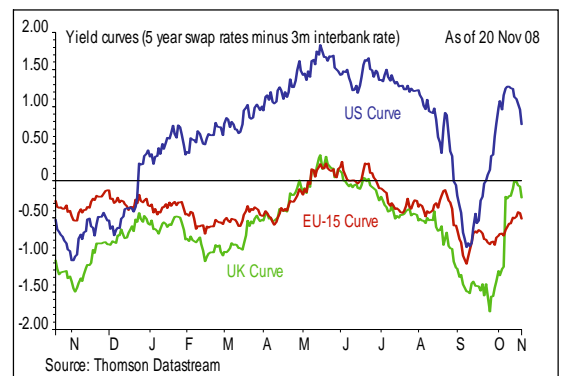
£/€ scaled 1.1998 this week



The biggest falls in bond yields this week were concentrated in the US where worries about the financial system and the solvency of the three largest car manufacturers sparked strong demand for the safe haven of government bonds. The Dow fell below 8,000 and the S&P 500 fell below 750, putting losses so far this year close to 50%. Moreover, US economic data is still not stabilising and this is compounding fears that the recession could be deeper than previously thought, causing ripples across the world economy. The Fed this week revised down its 2009 forecasts for growth and inflation, and turned more pessimistic about the labour market. Initial claims continued their ominous rise this week, climbing to 542,000. At the same time, October inflation data showed the first monthly fall in core CPI since 1982. The 0.1% fall led to a drop in annual core inflation to 2.2% from 2.5% in September. The combination of shrinking output growth and falling inflation led to a steep decline in treasury yields across the curve. 5yr swaps fell to an intra-week low of 2.81%, but closed the week at 2.97%, down an extraordinary 42bps from last week.

New all-time lows for the euro zone manufacturing and services PMI's in November underlined the threat of a more protracted period of negative gdp growth in the region. The resulting rise in spare capacity and expectations of a sharp fall in inflation pulled 10yr bund yields and 5yr swaps below 3.50%. The weak data will inevitably add pressure on the ECB to cut rates decisively when it meets in two weeks time. We expect rates to be cut in December by at least 0.50%.

Kenneth Broux, Economist Jeavon Loyal, Senior Economist Yield curves flattened this week



FOREIGN EXCHANGE - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: £/\$ briefly pushed above 1.52 this week

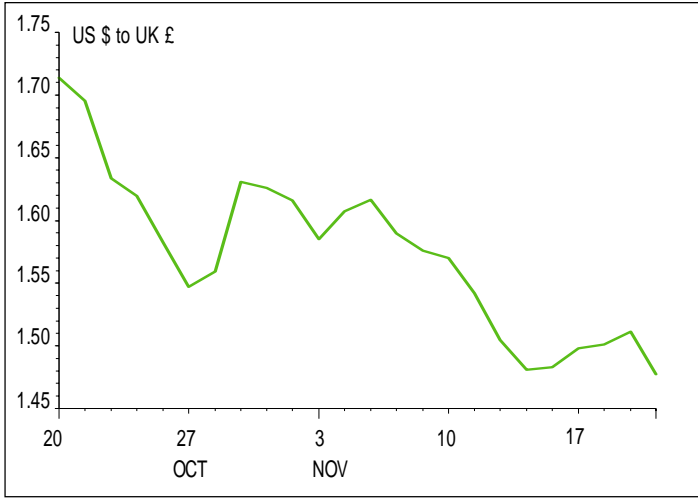


Chart 2: €/€ was volatile this week, falling back from 1.2814

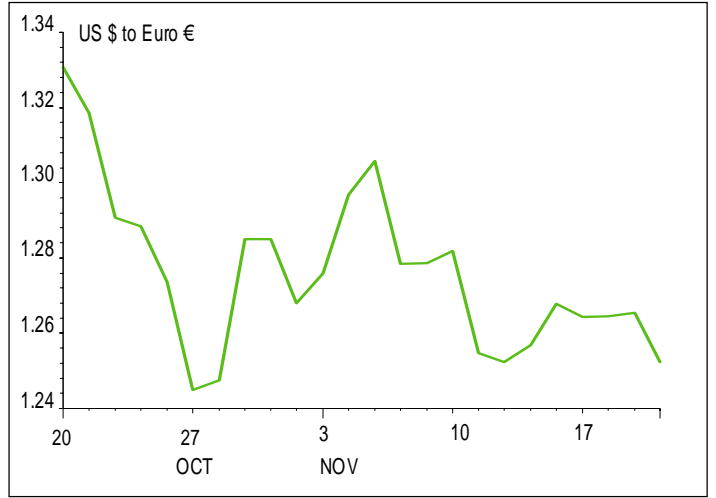


Chart 3: £/€ stayed below 1.20 this week

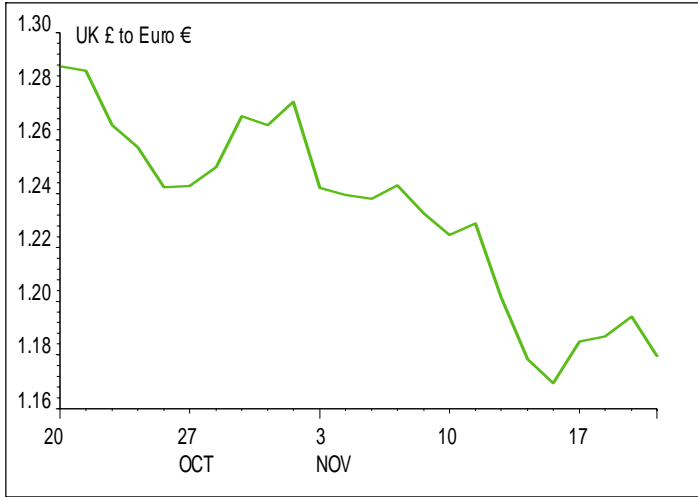


Chart 4: \$/¥ fell to a 3-week low on rising risk aversion

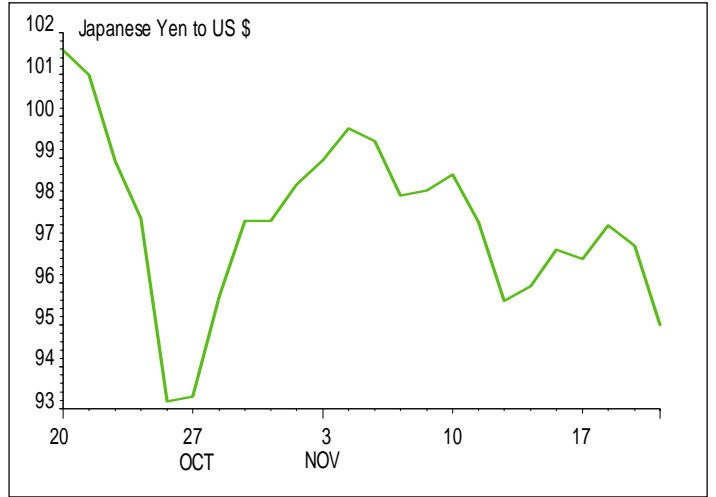


Chart 5: Loonie weakens as crude oil drops below \$50

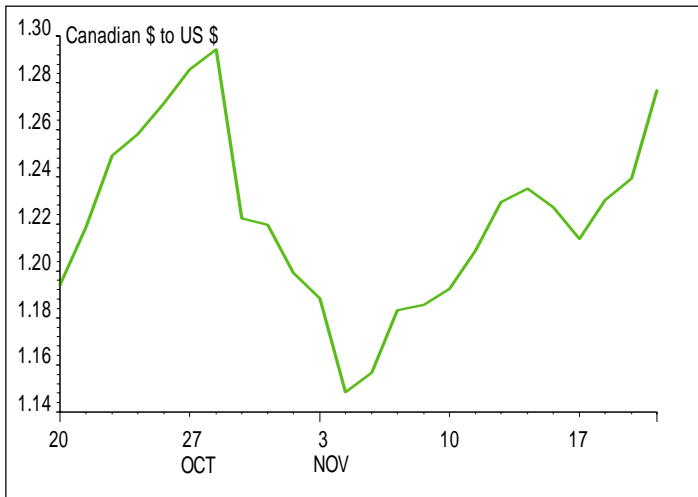
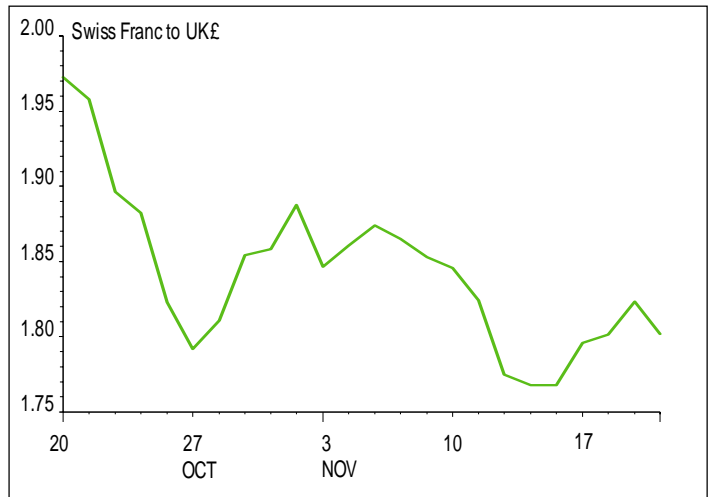


Chart 6: £/Chf rallied after the surprise SNB rate cut



FIXED INCOME - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: UK 2yr yields fell below 2%

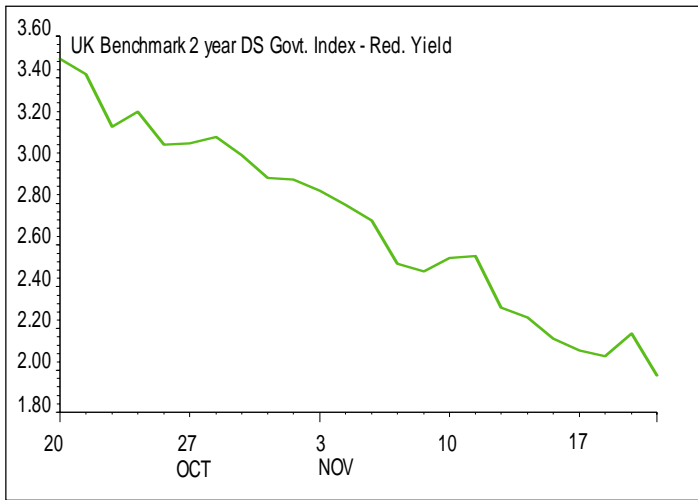


Chart 2: UK 10yr gilt now yields less than 4%

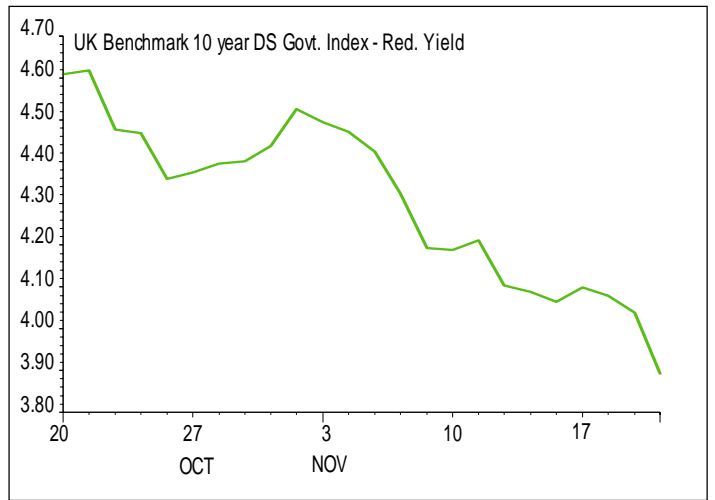


Chart 3: US 2yr yields fell below 1%

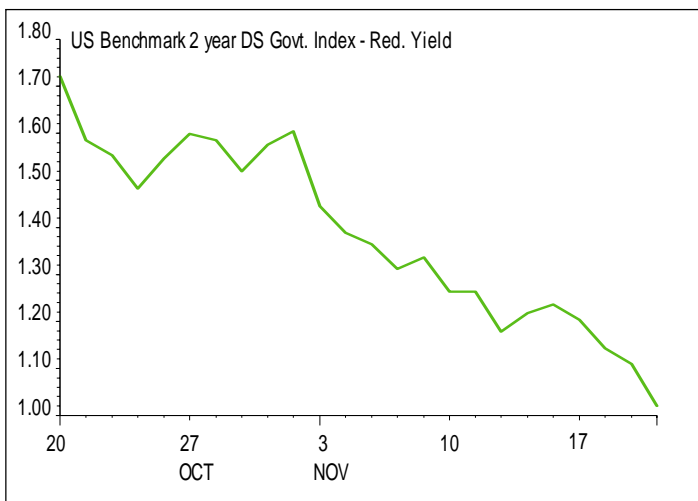


Chart 4: US 10yr yields hit an all-time low of 3.06%

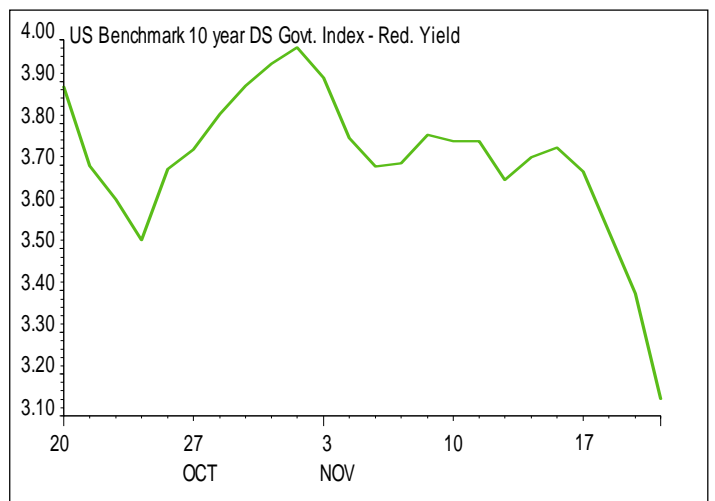


Chart 5: EU-15 2yr yields touched 2%

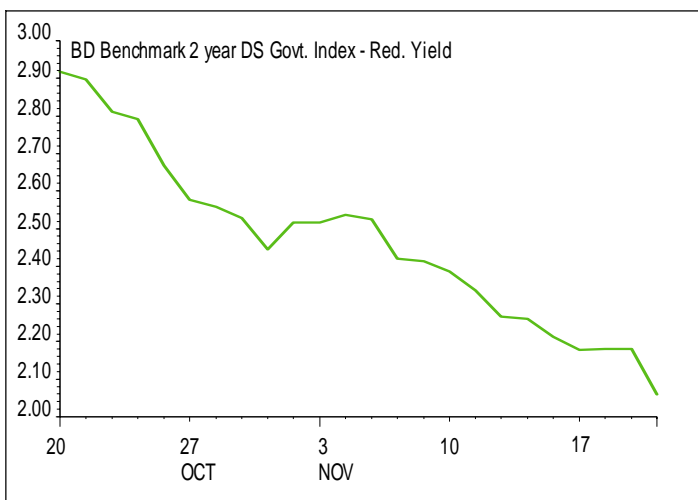
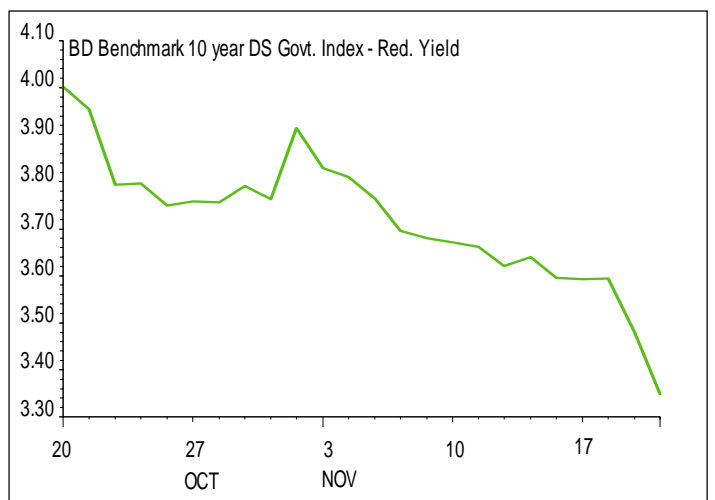


Chart 6: EU-15 10yr yields dropped below 3.50%



INTEREST RATE MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: US 5yr swaps fell more than 40bps



Chart 2: Eurozone 5yr swaps fell 19bps

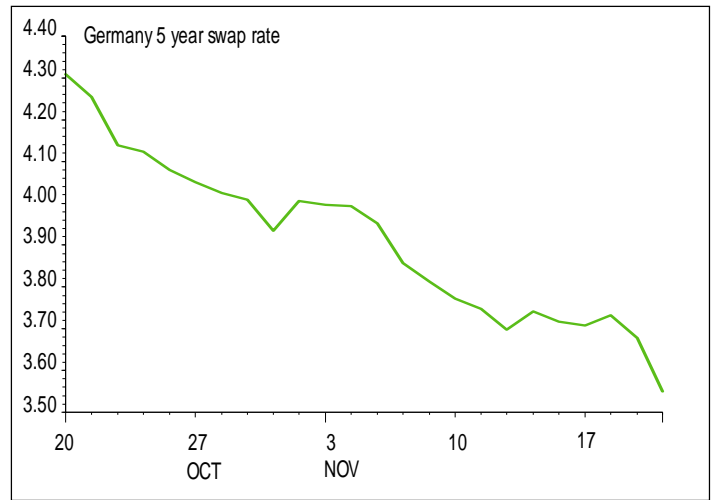


Chart 3: UK 5yr swaps dropped below 3.75%

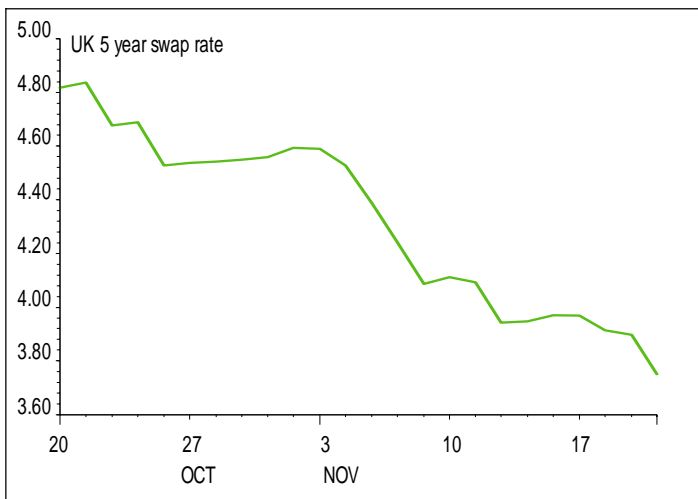


Chart 4: US yield curve flattened to 85bps

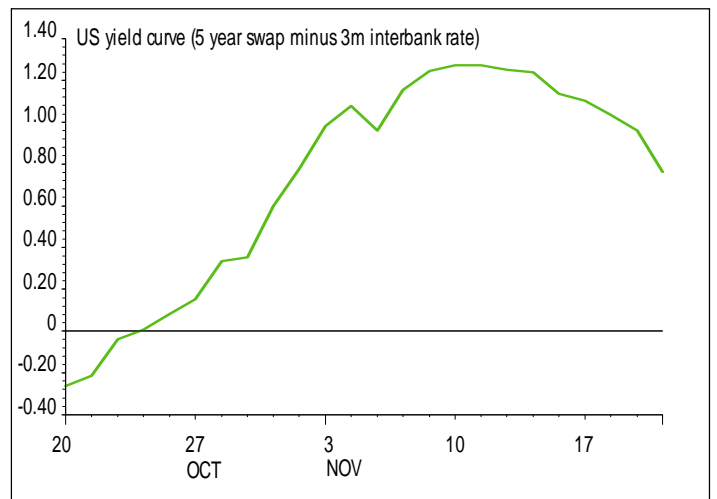


Chart 5: Euro zone curve flattened to -55bps

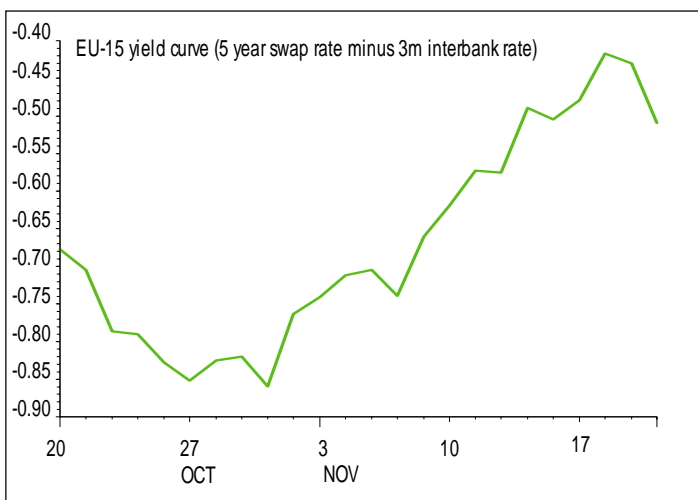
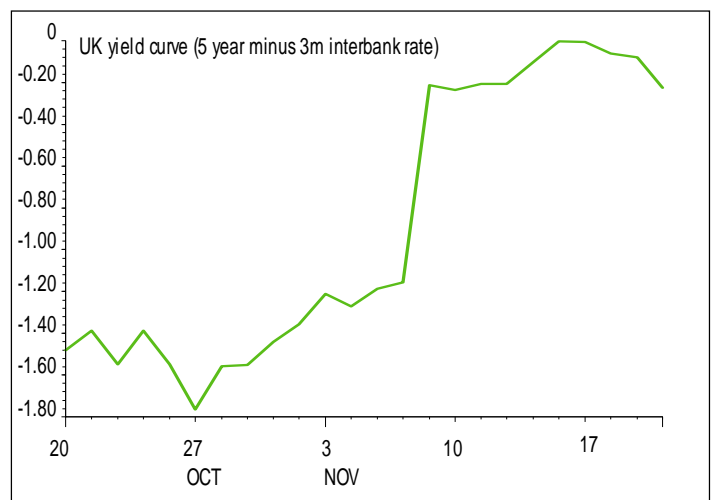


Chart 6: UK yield curve levels off at -20bps



KEY COMMODITY & EQUITY MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: Gold prices higher for a third straight week

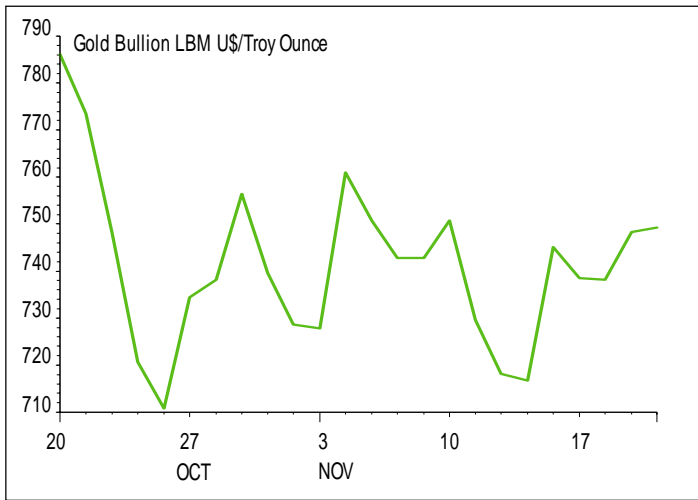


Chart 2: London Brent extended decline through \$50

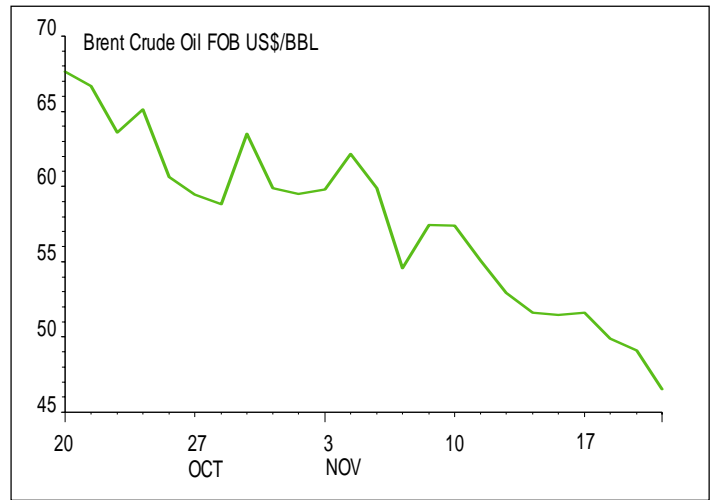


Chart 3: The FTSE-100 down by over 10% this week

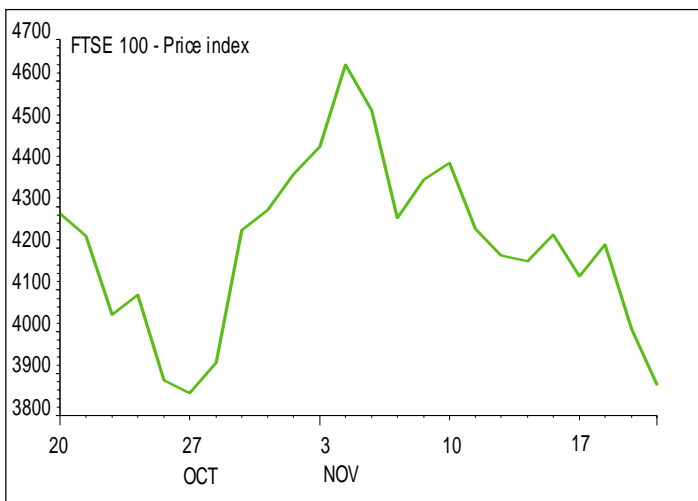


Chart 4: Dow Jones below 8,000

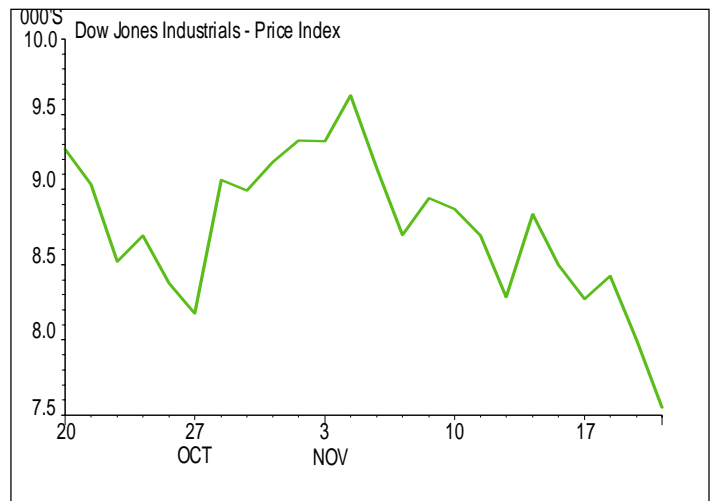


Chart 5: Nikkei still above recent lows

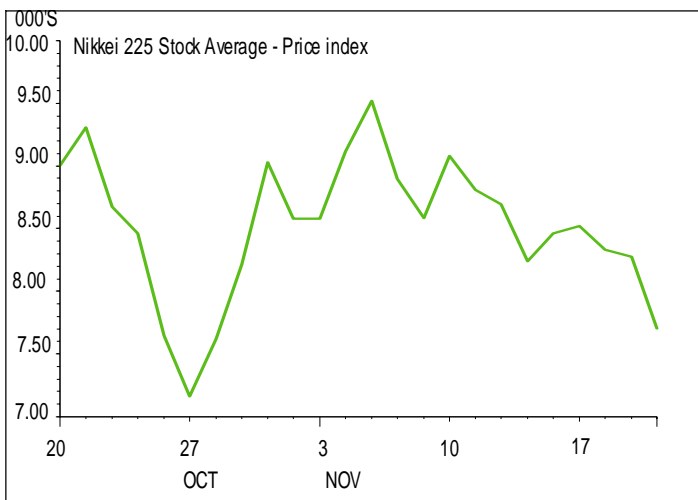
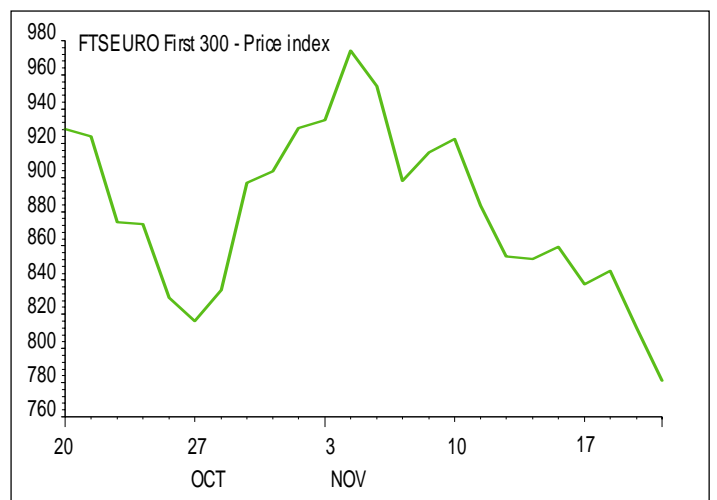


Chart 6: The Eurofirst 300 index is down almost 50% in 2008



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