



## Financial Markets Review

26 June 2009

### UK bond yields and swaps fall

*The pound made limited further headway this week following mixed UK economic data.*

*Volatility levels fell gradually over the week, reflecting the tighter trading ranges seen in £/\$ and £/€.*

*In emerging markets, the Chilean peso bucked the broader trend to strengthen against the USD as the government announced additional repatriation of its international assets.*

#### Financial market review - foreign exchange

Momentum in the pound has faded somewhat this week amid mixed economic data and Bank of England Governor King's concerns over the magnitude of the UK fiscal deficit. After recording a high on Monday (€1.1904), £/€ pulled back to close the week at 1.1738. £/\$ traded the week in the 1.6210-1.6602 range, closing today at 1.6505. Volatility levels continue to gradually fall in foreign exchange as the USD remains stable and range-bound. This stability is shown in today's close in the USD index, of 79.9, which is less than 0.2% away from the close 5 week's ago. AUD/USD and NZD/USD are relatively unchanged on the week, reflecting the small movement across commodity prices. Crude oil fell by only 1.2% this week. This has helped to keep the oil price sensitive currency pair, USD/NOK, stable over the week. The Swiss National Bank has intervened aggressively in the foreign exchange market to depreciate the Swiss franc. The SNB widened their stance to intervene in both EUR/CHF and USD/CHF. The SNB have not formally announced an explicit level which they would like to defend, instead expressing a desire to reduce excessive strength and volatility in the currency. However, intervention has occurred frequently as EUR/CHF approached SFr1.50. The SNB is likely to continue regular interventions to weaken the franc (which is being supported by the nation's current account surplus) whilst fighting deflation in Switzerland.

In emerging markets, the Colombian peso has been the worst performing currency against the USD. Concerns that the economy may be weaker than expected alongside the government's announcement of a larger fiscal deficit continue to provide a significant headwind for the peso, which has depreciated by 2.4% this week, following last week's 4.5% decline. The Brazilian real closed the week at 1.9473, strengthening 1.4% against the USD. Brazil is the world's largest exporter of sugar and the recent rise in sugar prices, which hit a 3-year high amid concerns of a poor crop in India, have been supportive of the real. China has renewed its call this week for a super-sovereign currency and that the SDR basket should be

#### Financial market rates, ending Fri. 26 June 2009

At 4.30pm 26 Jun 09		Change from 19 Jun 09 % change
<b>FTSE 100</b>	4241.01	-2.41%
<b>Exchange rates</b>		
US\$/UK£	1.6505	+0.33%
Euro €/UK£	1.1738	-0.60%
US\$/Euro €	1.4061	+0.94%
<b>Swaps - 5 year (mid)</b>		
		<b>basis points</b>
UK pound	3.60	-8.00
US dollar	2.92	-30.00
Euro	2.88	-7.00
<b>Bond yields - 10 year</b>		
UK	3.69	-11.00
US	3.52	-26.00
Euro	3.39	-11.00

broadened. Such announcements by China continue to have a short term negative impact on the USD.

It has been a relatively quiet week for UK data, dominated by the CBI distributive trades report. The reported sales index remained unchanged, at -17, in June providing a little disappointment to the market. US data have been more mixed. The Richmond Fed manufacturing index rose again and the latest durable goods orders report indicated another solid rise in orders over May. On the flip side, existing and new home sales were reported below market expectations. These mixed data helped to keep the USD in its current range.

The Federal Reserve announced that the Fed Funds Target Rate would remain unchanged at 0-0.25% and that the quantitative easing programme would continue within the existing parameters. The FOMC statement contained only a few subtle changes from the previous statement and as such only provided short term support for the USD. 2-year interest rate spreads between the Eurozone & US as well as between the UK & US have also been relatively stable over the week, allowing EUR/USD and GBP/USD to hold in ranges over the period.

#### €/£ hit a 2-week high of 1.4138



#### £/\$ attracts strong demand above 1.64



Strong demand at UK gilt and US treasury auctions, lower equity markets and a successful ECB one-year liquidity operation bolstered government bond markets and caused yields to fall along the curve.

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

- Industrial production (7/7)
- NIESR GDP (8/7)
- Trade balance (9/7)
- Producer prices (10/7)
- DCLG house prices (14/7)
- Inflation data (14/7)
- Labour market stats (15/7)

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

- Consumer credit (8/7)
- Trade balance (10/7)
- Import prices (10/7)
- Uni of Michigan conf. (10/7)
- Producer prices (14/7)
- Retail sales (14/7)
- Business inventories (14/7)

**2009 calendar of central bank meetings**

- European ECB** (1.00%)
- 2 July, 6 August, 3 September, 8 October
- US FOMC** (0-0.25%)
- 12 August, 23 September, 4 November, 16 December
- UK MPC** (0.50%)
- 9 July, 6 August, 10 September, 8 October

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

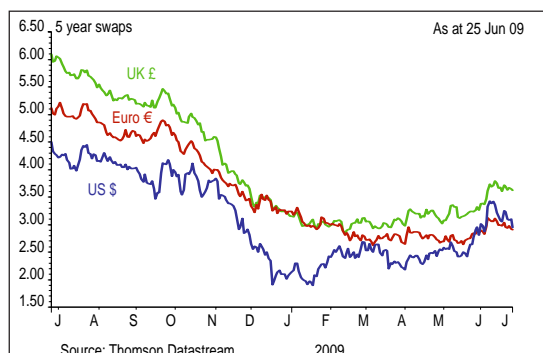
Strong demand at UK gilt and US treasury auctions, lower equity markets and a successful ECB one-year liquidity operation bolstered government bond markets and caused yields to fall along the curve. A change in language on inflation in the Fed FOMC statement briefly caused some profit taking, but yields subsequently resumed their decline to reach a 3-week low. Gilt yields also fell after BoE governor King and the Bank's Financial Stability Report warned that the financial system remains vulnerable to shocks and that the stabilisation of the economy could easily stall if lending to households and businesses does not improve. A sharper decline in short-term vs long dated yields in the UK caused the curve to steepen. Yield curves in the US and the euro zone flattened.

Except from BBA May mortgage approvals data on Tuesday and the CBI distributive trades survey on Thursday, there were no major UK data releases for markets to trade on. Mortgage approvals rose above 30,000 for the first time since April 2008, reaching 31,162. The CBI reported unchanged retail turnover in June vs May, but a further decline in inventories in Q2 could have implications for growth in the second half of the year. A rise in consumer demand could force retailers to increase inventories which in turn could boost GDP.

Solid follow through buying in short-dated fixed income paper squeezed UK, US and euro zone yields markedly lower over the first part of the week. UK 2y gilts yields dropped 19bp over the first three days to an intra-week low of 1.12% on Wednesday, outperforming US treasuries and German bunds. In their testimony to the House Select Committee on Wednesday, BoE governor King and other MPC members warned that a recovery in the UK economy would be a 'long, hard slog'. Governor King also hinted that the MPC could raise interest rates before it starts unwinding QE. The £4bn 2022 gilt auction on Thursday was covered 1.69 times, below the 1.80 average of the past two auctions. The BoE will buy £6.5bn of gilts under the APF next week, pushing the sum of purchases since March over the £100bn mark. 5y swaps ended the week 8bp lower at 3.60%. 3-month Libor fell 5bp to 1.20%.

In the US, follow-through buying from last week helped

**UK 5y swaps fell back to 3.60%**



**Naem Wahid, Economist**  
**Kenneth Broux, Market Economist**

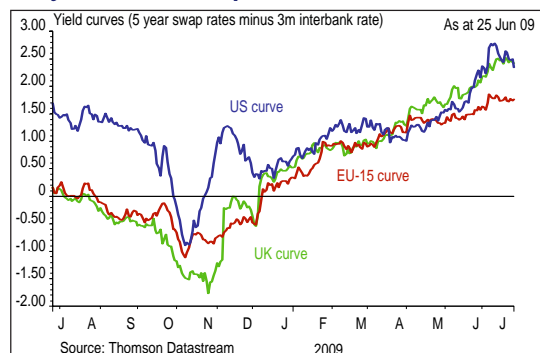
**£/€ fell back 0.6% but closed above 1.17**



treasury yields to extend their decline. A decline in oil prices below \$68, and a combination of weak existing homes sales data and lower equity supported the fall in yields ahead of the Fed FOMC meeting. The Fed left interest rates on hold at 0.25% but made a subtle change to its assessment of inflation enough to trigger profit taking in longer dated bonds and cause yields to back up. Deflation is no longer rated as the main threat by the Fed, but the view that inflation is likely to stay subdued and the commitment to keep interest rates low should help to keep yields capped at a time that the Fed continues to make treasury and MBS purchases. A worse than expected outcome for weekly initial and continuing claims helped treasury yields to resume their decline on Thursday, despite a 2% rally in the Dow and S&P. Strong demand for the three treasury auctions (\$104bn in total) and impressive overseas bidding helped to allay concerns about diversification of overseas dollar holdings and underscored the fact that a spiralling US public deficit and treasury issuance are (so far) not dampening demand for US debt. With no treasury supply scheduled for next week and participants preparing for the June employment report, bonds should continue to attract decent levels of support. 5y swaps fell 30bp to 2.92%.

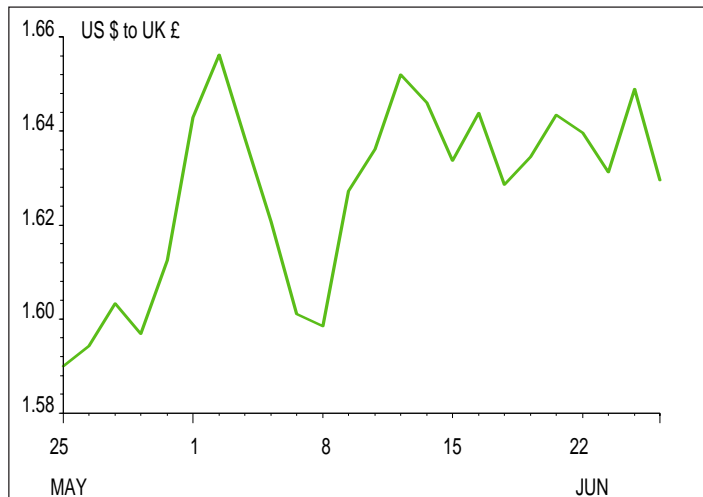
The ECB eased credit conditions on Tuesday when it offered 441bn euros in one-year liquidity to 1,120 banks. This helped 3-month libor to fall 8bp this week to 1.15%, posting the biggest decline vs UK and US equivalents. Weaker than expected flash PMI data for services sector activity fuelled concerns about the path to economic recovery. This helped to push 2y bunds yields below 1.30%, capping a drop of 48bp since June 11bp. 5y swaps closed 7bp lower at 2.88%.

**UK yield curve steepened**



# Foreign exchange - graphical analysis of recent trends

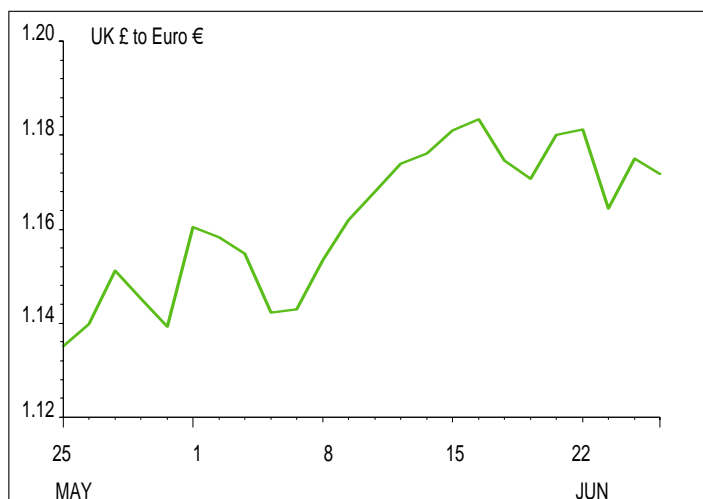
**Chart 1: £/\$ shows resilience above 1.64**



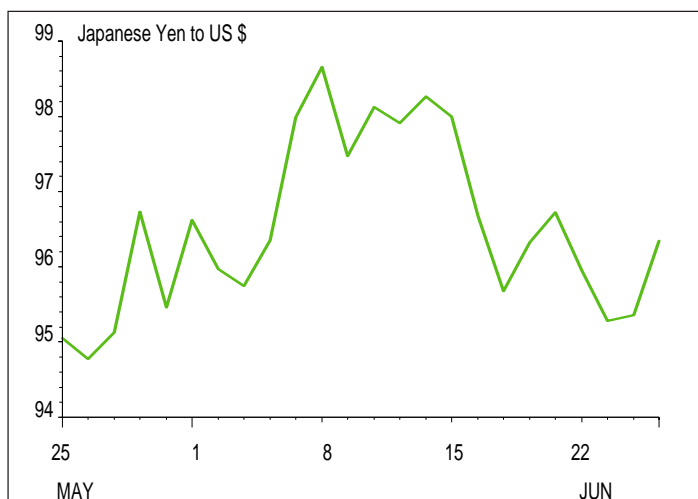
**Chart 2: €/€ closed the week above 1.40**



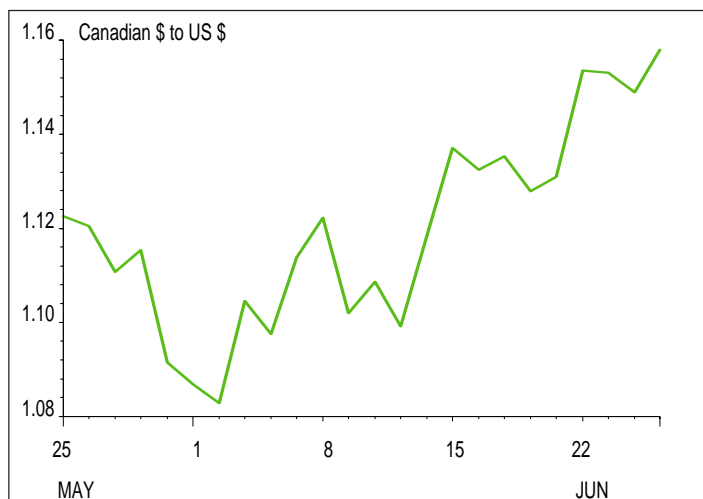
**Chart 3: £/€ holds up above 1.17**



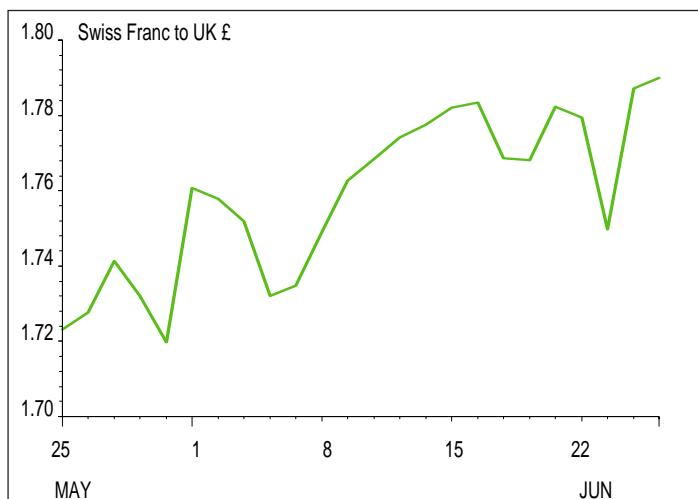
**Chart 4: \$/¥ fell back below 96.0 on Friday**



**Chart 5: \$/CS hit a one-month high of 1.1638**



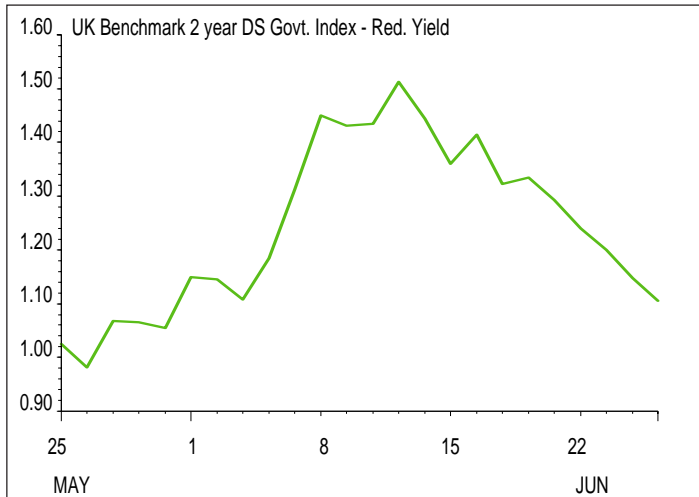
**Chart 6: £/Chf spiked up on SNB intervention**



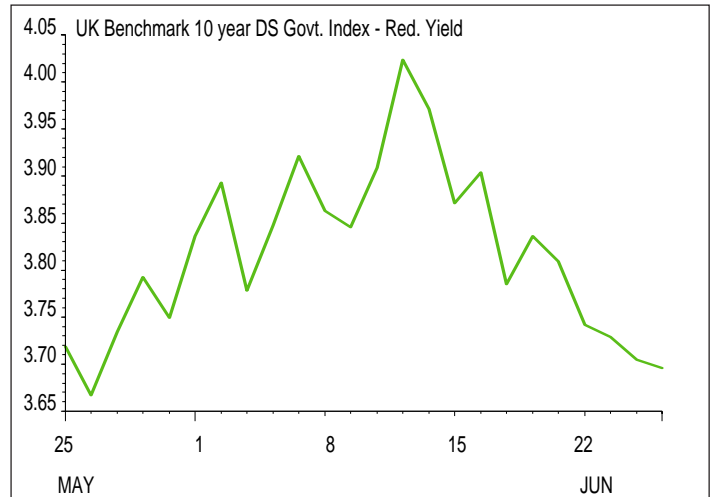
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Fixed income - graphical analysis of recent trends

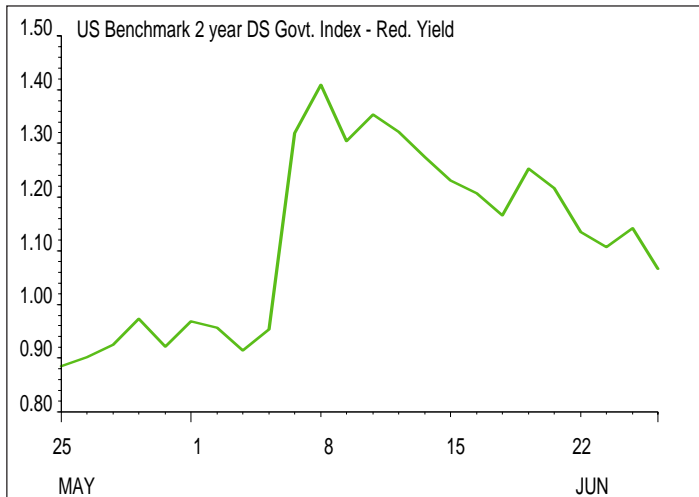
**Chart 1: UK 2yr yields dropped below 1.20%**



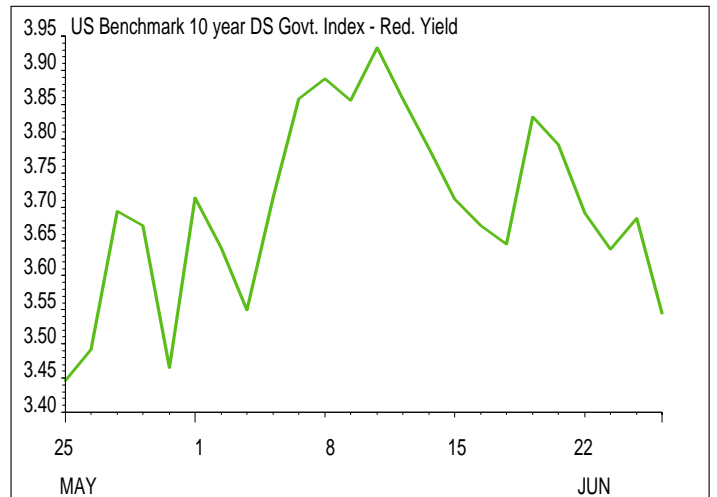
**Chart 2: UK 10yr yields fell below 3.70%**



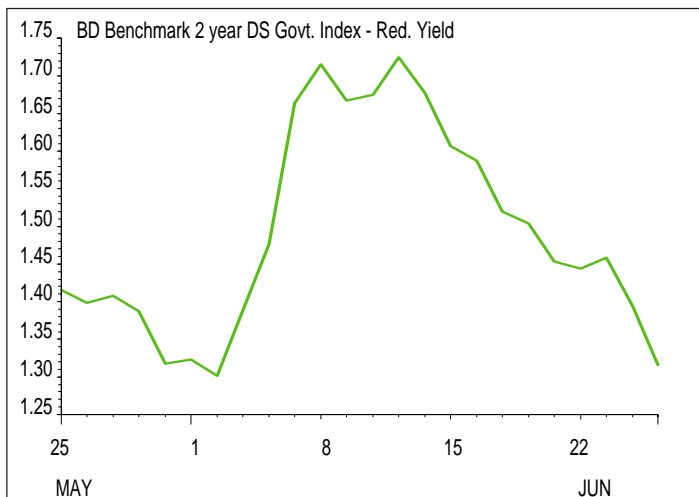
**Chart 3: US 2yr yields fell back to 1.10%**



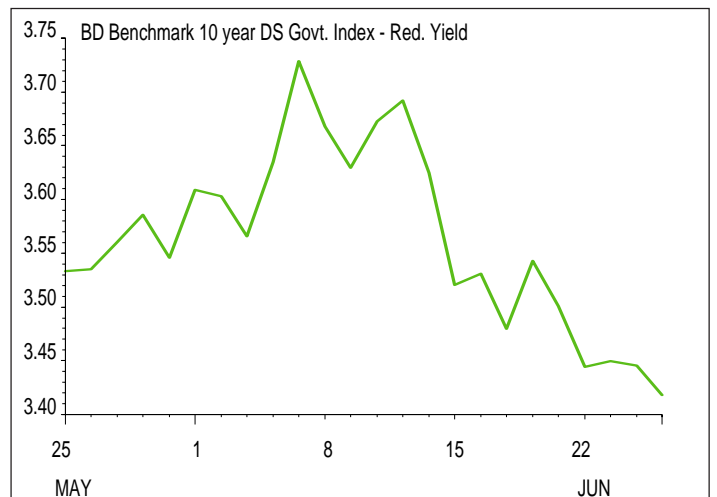
**Chart 4: US 10yr yields dropped to 3.50%**



**Chart 5: EU-16 2yr yields fell below 1.30%**



**Chart 6: EU-16 10yr yields slipped to 3.40%**



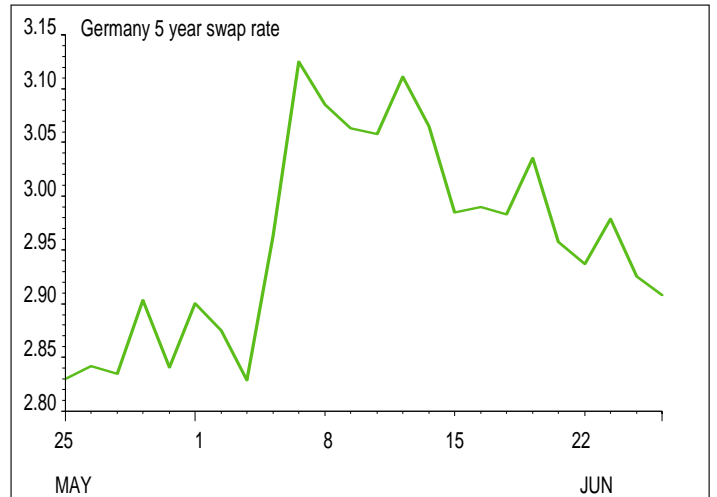
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Interest rate markets - graphical analysis of recent trends

**Chart 1: US 5yr swaps fell back below 3%**



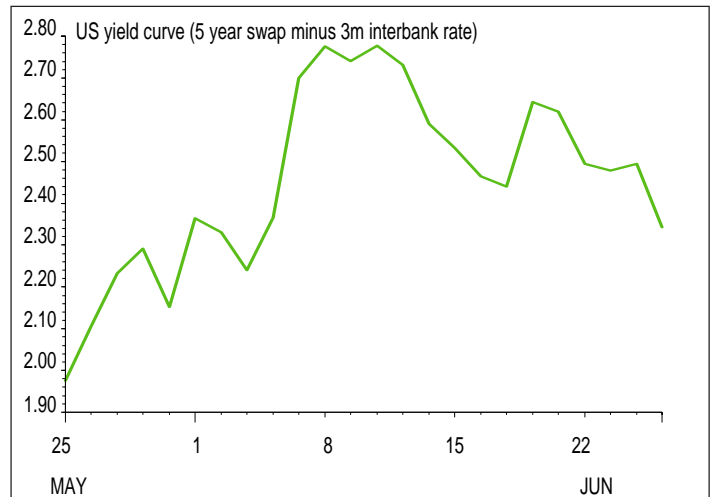
**Chart 2: Euro 5yr swaps dropped to 2.90%**



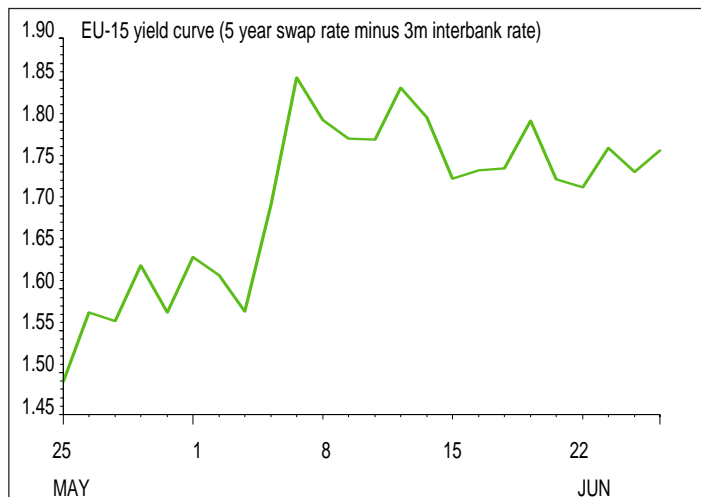
**Chart 3: UK 5yr swaps eased to 3.60%**



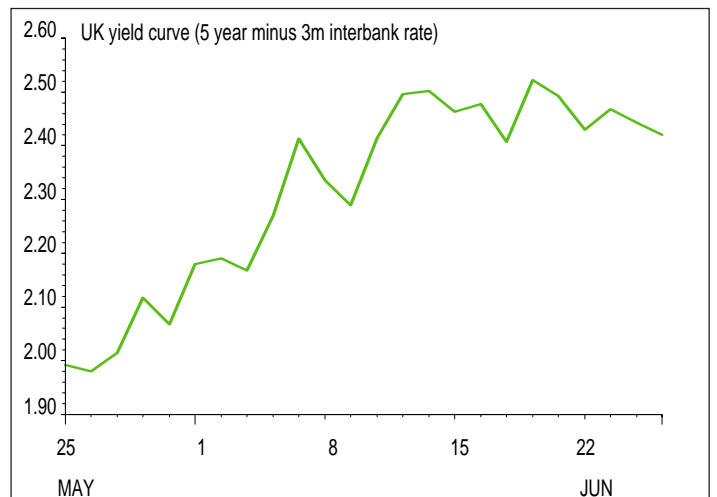
**Chart 4: US curve flattened on fall in long-term yields**



**Chart 5: Eurozone curve was fairly flat**



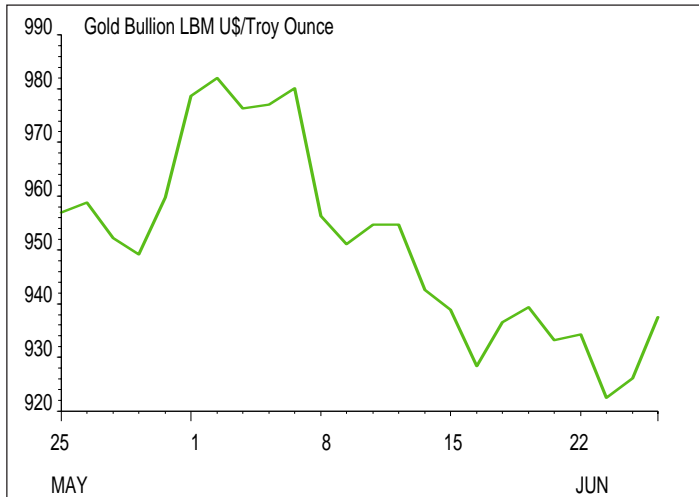
**Chart 6: UK curve stayed rangebound**



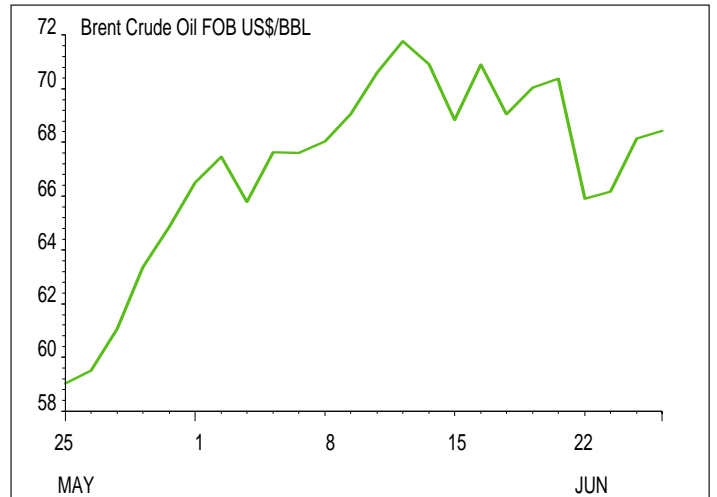
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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

**Chart 1: Gold rebounded above \$940**



**Chart 2: Oil prices closed below \$70**



**Chart 3: The FTSE-100 dropped 2.5%**



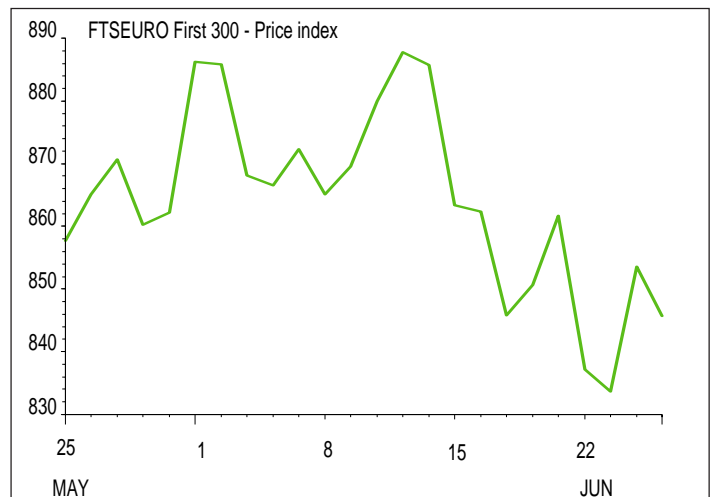
**Chart 4: The Dow Jones lost ground on Fed statement**



**Chart 5: The Nikkei closed above 9,800, up 0.9%**



**Chart 6: The EuroFirst 300 closed the week below 850**



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

## Client Support

### Economic Research Team

Trevor Williams	+44 (0)20 7158 1748	trevor.williams@lloydstsb.co.uk
Nichola James	+44 (0)20 7158 1741	nichola.james@lloydstsb.co.uk
Jeavon Lolay	+44 (0)20 7158 1742	jeavon.lolay@lloydstsb.co.uk
Hann-Ju Ho	+44 (0)20 7158 1745	hann-ju.ho@lloydstsb.co.uk
Kenneth Broux	+44 (0)20 7158 1750	kenneth.broux@lloydstsb.co.uk
Rabia Bhopal	+44 (0)20 7158 1747	rabia.bhopal@lloydstsb.co.uk
Nikesh Sawjani	+44 (0)20 7158 1749	nikesh.sawjani@lloydstsb.co.uk
Paul Rodriguez	+44 (0)20 7158 1744	paul.rodriguez@lloydstsb.co.uk

### Support/Administration

Sarah Pedder, <i>Distribution</i>	+44 (0)20 7158 1746
Mandy Wright, <i>Distribution</i>	+44 (0)20 7158 1746
Hugh Geen, <i>Information Manager</i>	+44 (0)20 7158 1740
Caroline McDonagh, <i>Graphic Designer</i>	+44 (0)20 7158 1743

### Customer Sales

Andrew Willett	+44 (0)20 7158 1616	andrew.willett@lloydstsb.co.uk
Kathryn Ball	+44 (0)20 7158 1672	kathryn.ball@lloydstsb.co.uk

### Capital Markets Distribution

Ton Roeten	+44 (0)20 7158 1715	ton.roeten@lloydstsb.co.uk
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