



# Financial Markets Review

27 March 2009

## Failed UK bond auction alarms investors

*The first 'failed' UK bond auction for seven years dented sterling and pushed gilt yields higher as investors worried about the UK's large financing requirement.*

*Weak UK economic data also weighed on the pound this week.*

*The dollar benefited this week from confidence behind the latest government proposals to support the US banking sector.*

*The euro weakened on rising speculation that the ECB will cut interest rates next week.*

### Financial market review - foreign exchange

The latest major initiative by the US government to stabilise its banking sector and boost lending raised wider market confidence this week. The plan to remove the 'troubled assets' from bank balance sheets by providing finance and incentives for buyers led to a sharp rally in equities and buoyed commodities. Within the G10, the currencies of the major commodity exporters - Australia, New Zealand and Canada - recorded the only gains against the US\$ this week. However, the Norwegian krone saw the biggest fall, despite crude oil extending its recent gains, after the Norges bank cut interest rates by 0.5% to 2% and also signalled further easing was likely. The US\$ recorded solid gains against its main trading counterparts, particularly the yen and the euro. \$Y fell 2.4% to 98.0, as economic data from Japan disappointed, while rising speculation that the ECB will cut interest rates at its meeting next week saw €/€ drop 2.3% to 1.3269. In emerging markets, Asian currencies recorded gains against the \$ this week, led by the South Korean won. However, a combination of speculation of lower interest rates and political uncertainty saw Eastern European currencies register sharp falls.

Although a surprise rise in annual CPI inflation in February, to 3.2% from 3% in January, triggered a strong rally for sterling earlier in the week, it was later weighed down by some worse than anticipated UK economic data. The final estimate of Q4 2008 real GDP growth was revised down to -1.6%, from -1.5% previously, the biggest fall since Q2 1980. The details showed a sharp 1% fall in consumer spending, down from a fall of 0.7% in the last estimate, as households retrenched. The household saving ratio rose to 4.8% in Q4 2008, from 1.7% in the third quarter. Already strong prospects of a further sharp fall in consumer spending in the first quarter of 2009 were firmed by figures showing the volume of retail sales fell by 1.9% in February, the most since June 2008, while the CBI distributive trades' survey painted another bleak prospect for retailers in March. The first failed gilt auction since 2002, with total bids of £1.63bn short of the £1.75bn on offer, also weighed on sterling this week. At the close

### Financial market rates, ending Fri.27 Mar 2009

At 4.30pm 27 Mar 09		Change from 20 Mar 09 % change
<b>FTSE 100</b>	<b>3898.9</b>	<b>+1.46%</b>
<b>Exchange rates</b>		
US\$/UK£	1.4300	-1.18%
Euro €/UK£	1.0776	+1.12%
US\$/Euro €	1.3269	-2.28%
<b>Swaps - 5 year (mid) basis points</b>		
UK pound	3.10	+15.0
US dollar	2.31	-1.0
Euro	2.75	+3.0
<b>Bond yields - 10 year</b>		
UK	3.28	+25.0
US	2.74	+12.0
Euro	3.09	+11.0

on Friday, £/\$ ended down 1.2% at 1.4300. However, a strong rally on Friday saw £/€ close 1.1% higher at 1.078.

It was another rollercoaster week for the US\$, with a variety of key factors driving it along. After the sharp fall last week, there was understandably nervousness ahead of US Treasury Secretary Tim Geithner's latest proposals to support the US banking sector. In the event, investors appeared supportive of the plans, providing some support for the \$. However, Mr Geithner later had to reassure markets that the \$ was the world's reserve currency after saying he would consider proposals for a new 'super sovereign reserve currency'. US economic data this week were overall better than expected, although annualised GDP growth in the final quarter was revised down slightly to -6.3%. However, it was weak figures from other major economies that perhaps provided the main upward impetus for the \$ this week, with the dollar index rallying strongly through 85 on Friday. Rising speculation that the ECB will cut interest rates at its meeting next week was the main driver behind the € this week. We forecast a 0.5% reduction to 1%.

€/€ fell sharply on Friday



£/\$ briefly fell below 1.43 on Friday



The DMO appeared to partly blame the Bank of England for pushing gilt yields too low.

### Rolling calendar of UK data releases and events

Industrial production (7/4)  
 Manufacturing output (7/4)  
 NIESR GDP estimate (8/4)  
 Producer prices (9/4)  
 Official house prices (15/4)  
 Trade balance (16/4)  
 CPI inflation (21/4)

### Rolling calendar of US data releases and events

Consumer credit (7/4)  
 Trade balance (9/4)  
 Import prices (9/4)  
 Producer prices (14/4)  
 Retail sales (14/4)  
 Business inventories (14/4)  
 Consumer prices (15/4)

### 2009 calendar of central bank meetings

**European ECB** (1.50%)  
 2 April, 7 May, 4 June, 2 July, 6 August, 3 September  
**US FOMC** (0-0.25%)  
 29 April, 24 June, 12 August, 23 September  
**UK MPC** (0.50%)  
 9 April, 7 May, 4 June, 9 July, 6 August, 10 September

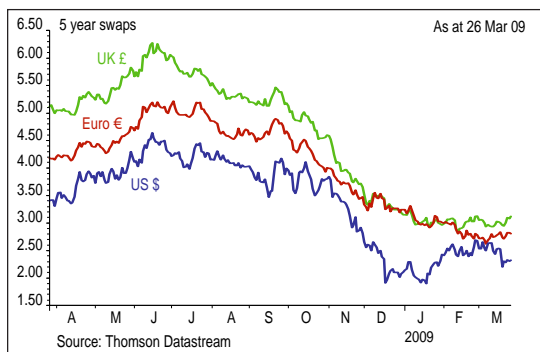
### Interest rate market review - bonds, cash and swaps

It was a very volatile market for UK gilts, as the surprisingly strong February inflation numbers and the failed auction of the 2049 paper sent bond yields soaring. The benchmark 10yr bond yield hit a high of 3.53%, reversing almost all the declines since the Bank of England announced it would begin buying gilts. The national statistics office on Tuesday revealed that CPI inflation actually rose to 3.2% from 3.0%, in contrast with expectations of a fall in 2.6%, while the RPI measure fell to 0.0% from 0.1%. The stronger-than-expected inflation data was mainly due to higher import prices, suggesting that the pound's 20% or so decline in the past year may be having more of an upward effect on inflation than anticipated. CPI inflation is still expected to fall significantly in the coming months below the 2% target, but the pace of decline may be less rapid than previously thought.

On the same day, Bank of England Governor Mervyn gave an extraordinary warning against another large rise in public spending at the forthcoming Budget. On the following day, a gilt auction failed for the first time in nearly 7 years, with the 2049 issue covered 0.93 times. This raised general concerns about the willingness and ability of the private sector to digest the expected glut of bond issuance to finance the government's rising fiscal deficits. Astonishingly, the DMO appeared to partly blame quantitative easing by the Bank of England for pushing gilt yields to unattractive levels for investors. The confusion did nothing to support gilt prices, though some of the rise in bond yields was reversed after the Bank bought more gilts, as part of its quantitative easing policy. Bond yields also fell from highs when official data showed retail sales slumped 1.9% in February, while the CBI's distributive trades' survey for March showed a further weakening of retail activity. Moreover, Q4 GDP was revised down to -1.6% from -1.5%, as the national account revealed a sharp rise in the household savings ratio to 4.8% from 1.7%. Over the week, 10yr gilt yields ended up 25bps to 3.28%, while 2yr yields fell 4bps to 1.30%. 5yr swaps rose to 3.10% from 2.95%, while 3m libor fell 7bps to 1.68%.

In the euro zone, bond yields were supported by higher equity prices and Germany selling €5.7bn of 5yr paper. Although the manufacturing and services PMI surveys

### Swap rates rose strongly in the UK



Jeavon Lolay, Senior Economist  
 Hann-Ju Ho, Senior Economist

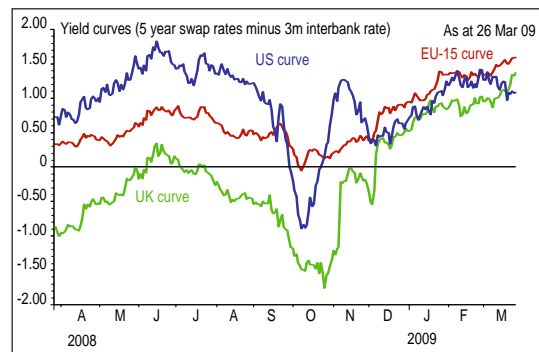
### £/€ briefly rose above 1.09 this week



were slightly better than expected, they remained at very weak levels and do not alter expectations that the ECB will cut interest rates again next week. Moreover, euro zone industrial orders fell 34.1% on the year and the German Ifo survey declined to 82.1 from 82.6, the latter confirming the country's dire economic situation following the collapse of world trade volumes. Germany also reported a bigger-than-expected fall in preliminary March CPI inflation to 0.4% from 1.0%. Hence, the ECB is expected to cut interest rates next week by 50bps to 1%. ECB vice-president Papademos hinted that the ECB may decide to buy corporate bonds and extend the maturity of its lending to banks, hence markets will be closely scrutinising President Trichet's comments following the rate announcement. Over the week, benchmark 10yr bund yields rose 11bps to 3.09%, while 2yr yields fell 1bp to 1.31%. 5yr swaps slightly higher at 2.75% and 3m libor fell 4bps to 1.525%.

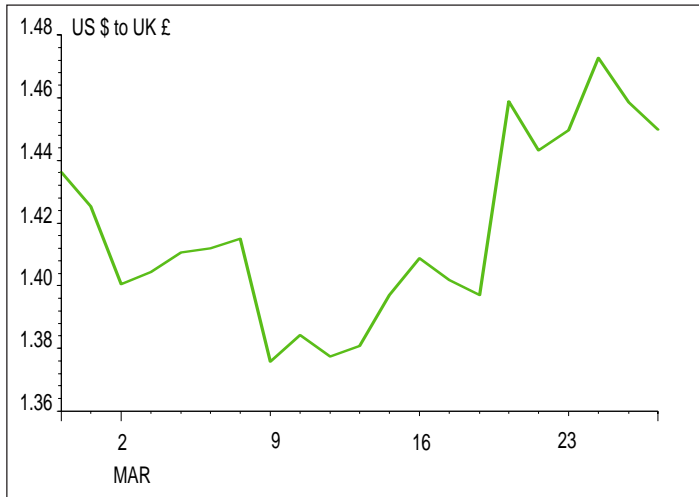
US equities markets rose strongly after the Treasury announced plans to remove toxic assets from banks' balance sheets, though the initial bond market reaction was calm. Nevertheless, supply issues this week helped push yields higher, with 10yr yields peaking at 2.83%, before settling up 12bps on the week at 2.74%. 2yr bond yields hit a high of 0.97%, while 3m libor was little changed at 1.22%. Some of the data surprised on the upside, including durable goods orders and new home sales, while Q4 GDP was revised down less than expected to 6.3%. Markets will be focusing on next week's employment report, which is expected to show another large fall in non-farm payrolls and a further rise in the unemployment rate.

### Yield curves steepened

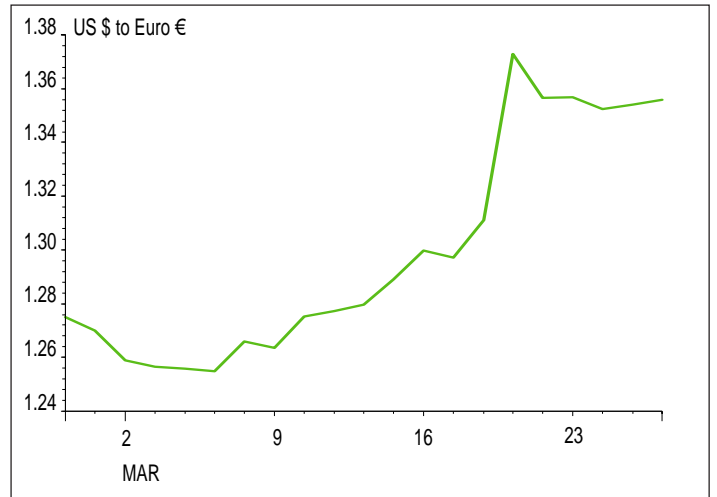


# Foreign exchange - graphical analysis of recent trends

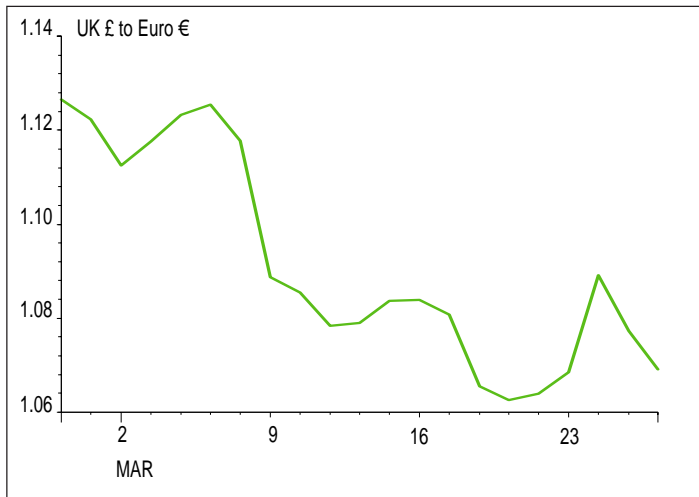
**Chart 1: £/\$ closed at 1.43 on Friday**



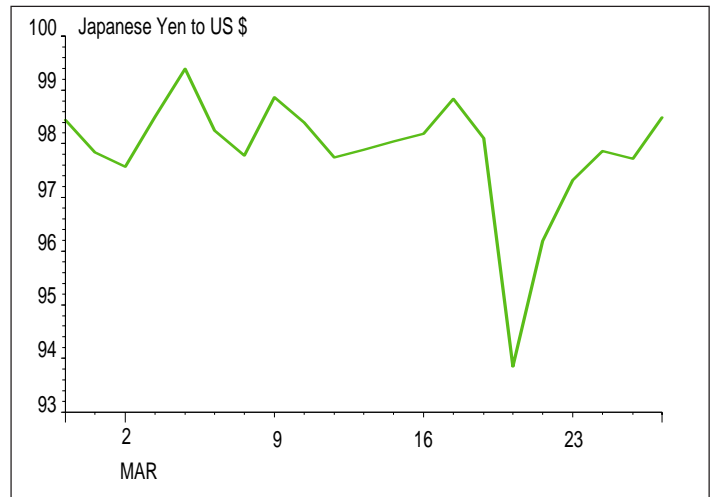
**Chart 2: €/€ dipped sharply on Friday, falling below 1.33**



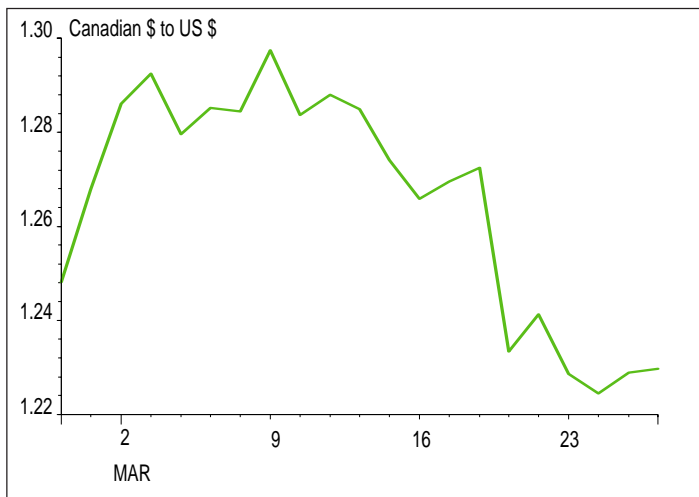
**Chart 3: £/€ rallied to close the week higher**



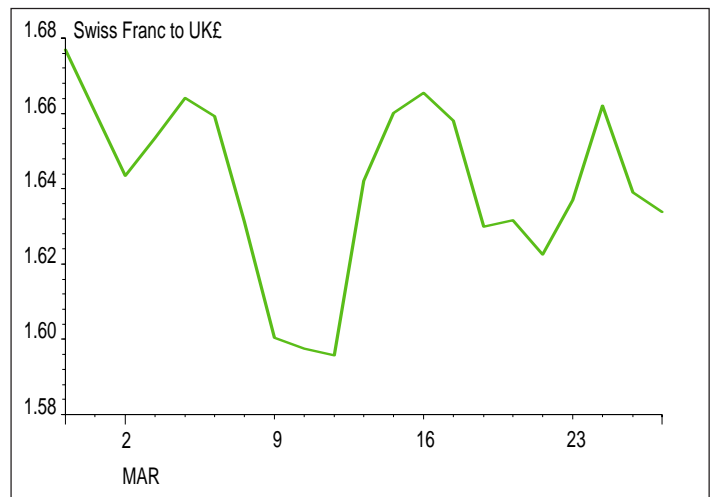
**Chart 4: \$/¥ remained under 100**



**Chart 5: Higher oil prices supported the loonie**



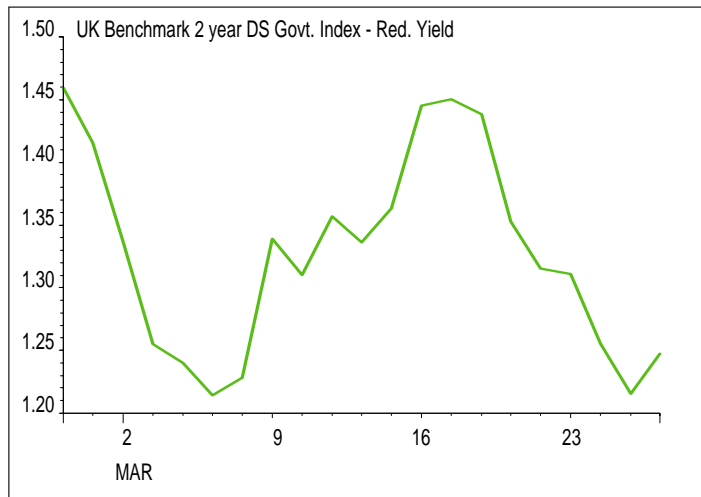
**Chart 6: £/Chf had a volatile week**



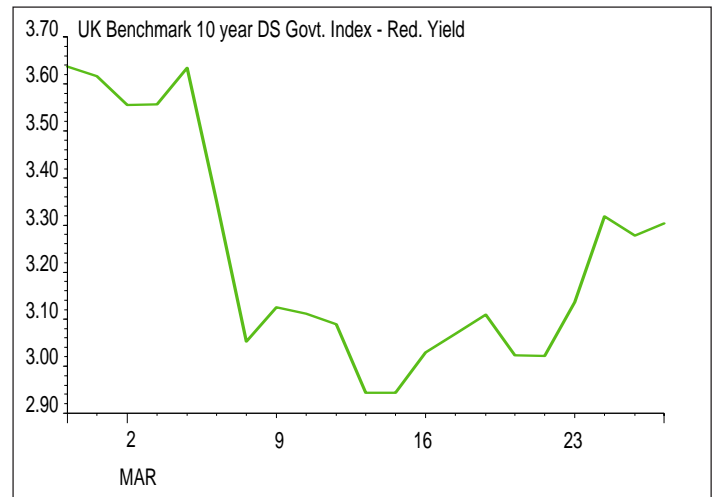
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Fixed income - graphical analysis of recent trends

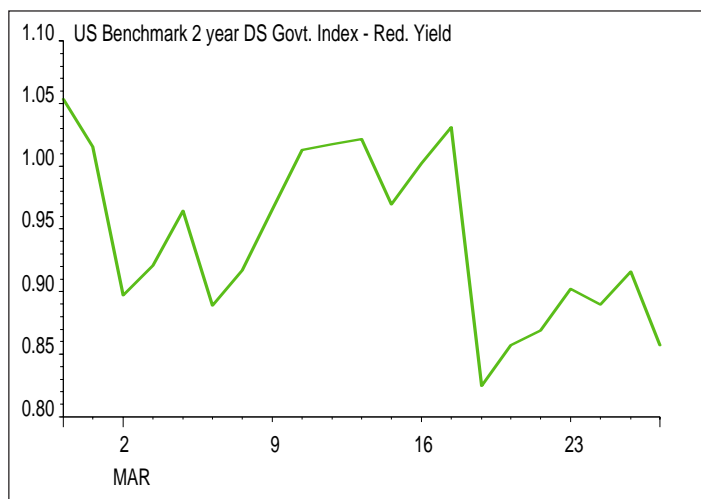
**Chart 1: UK 2yr yields stayed at low levels**



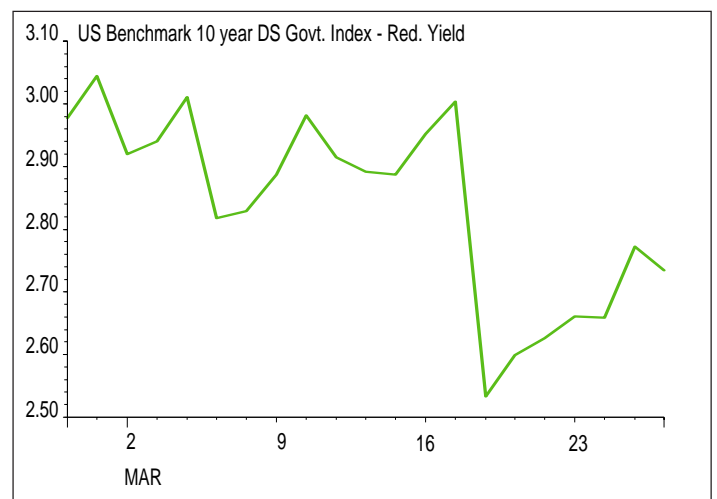
**Chart 2: UK 10yr yields soared this week**



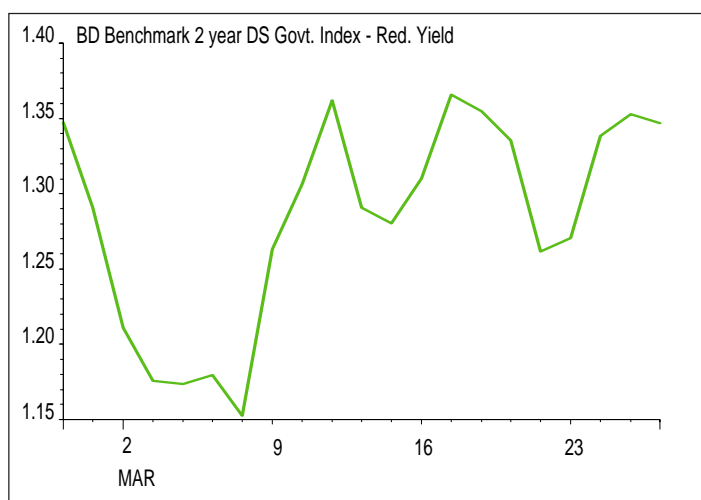
**Chart 3: US 2yr yields remained below 1%**



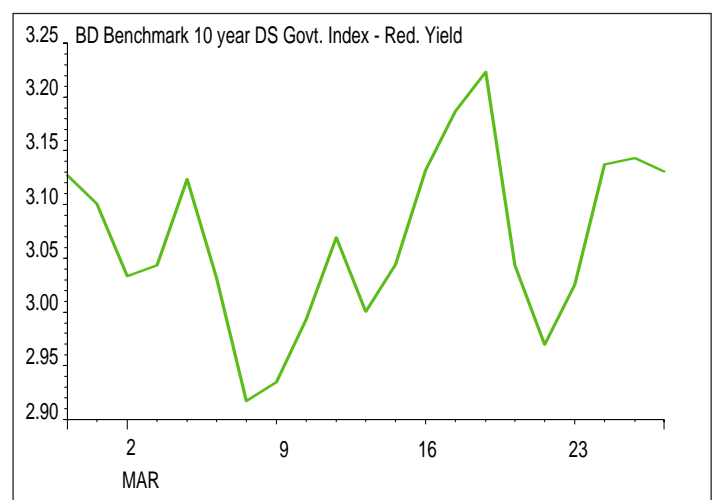
**Chart 4: US 10yr yields rose 11bps to 2.74%**



**Chart 5: EU-15 2yr yields ended near the week's lows**



**Chart 6: EU-15 10yr yields rose above 3%**



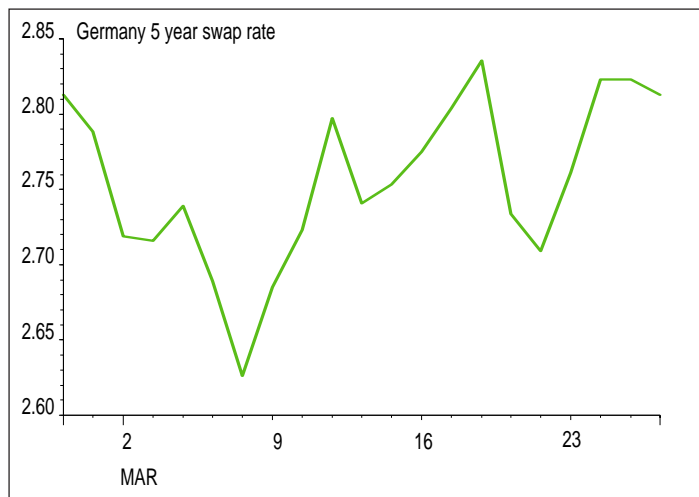
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Interest rate markets - graphical analysis of recent trends

**Chart 1: US 5yr swaps little changed on the week**



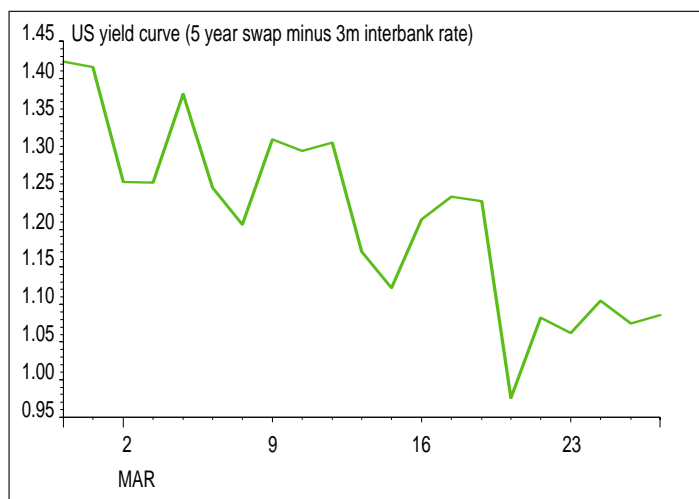
**Chart 2: Eurozone 5yr swaps rose slightly to 2.75%**



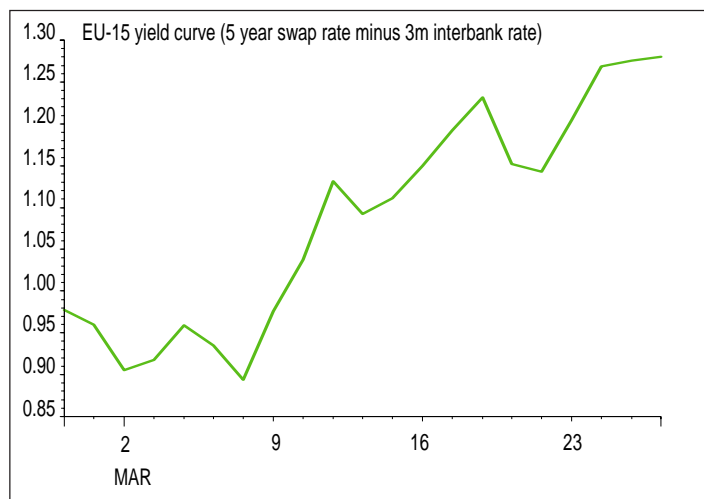
**Chart 3: UK 5yr swaps surged above 3%**



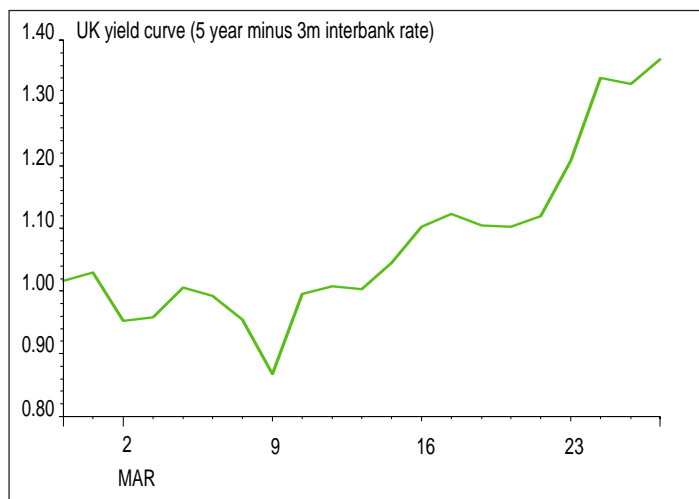
**Chart 4: US curve has flattened slightly in recent weeks**



**Chart 5: Eurozone curve steepened further**



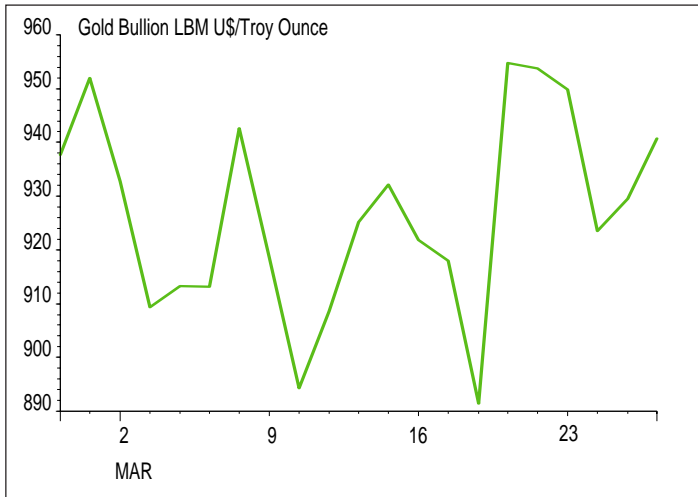
**Chart 6: UK curve steepened sharply, as swaps rose**



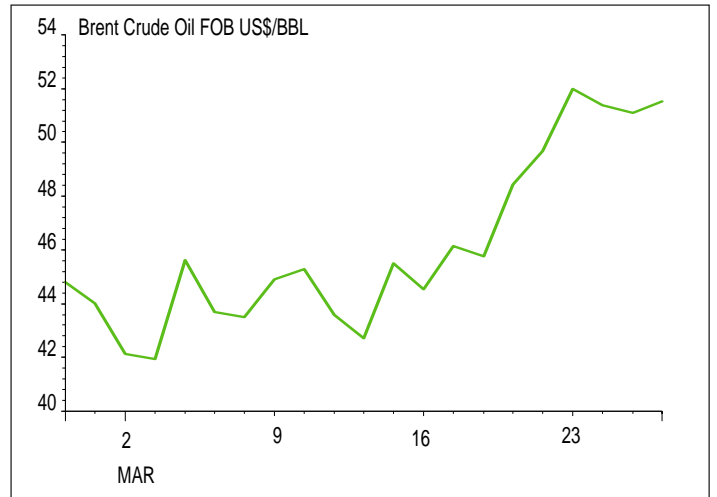
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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

**Chart 1: Gold fell, as the US dollar gained**



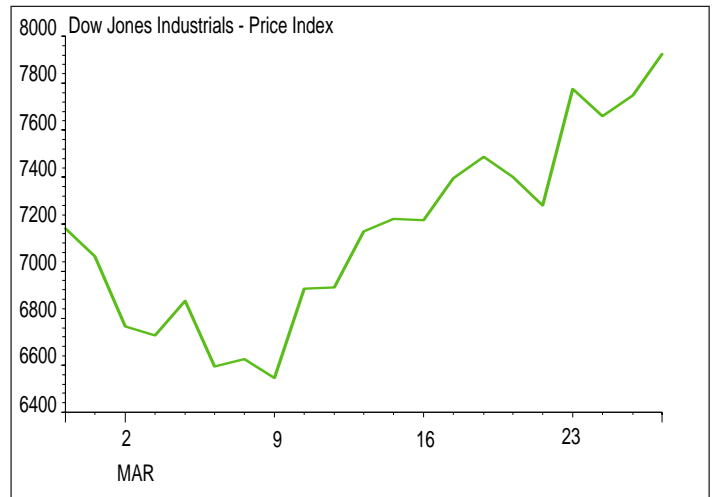
**Chart 2: London Brent stayed above \$50**



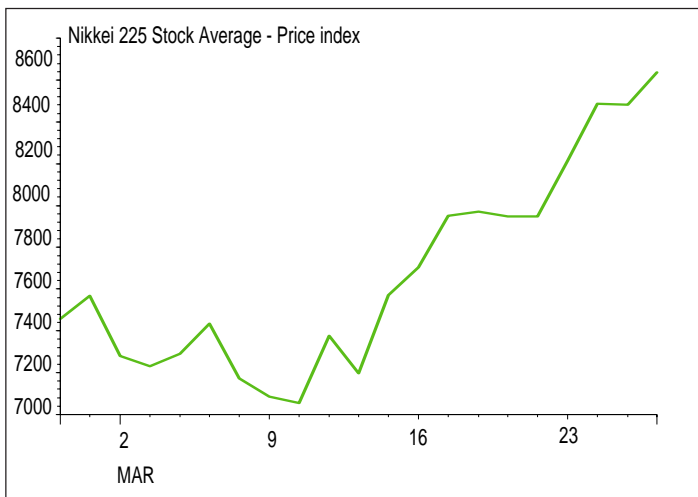
**Chart 3: FTSE-100 has risen back towards 4,000**



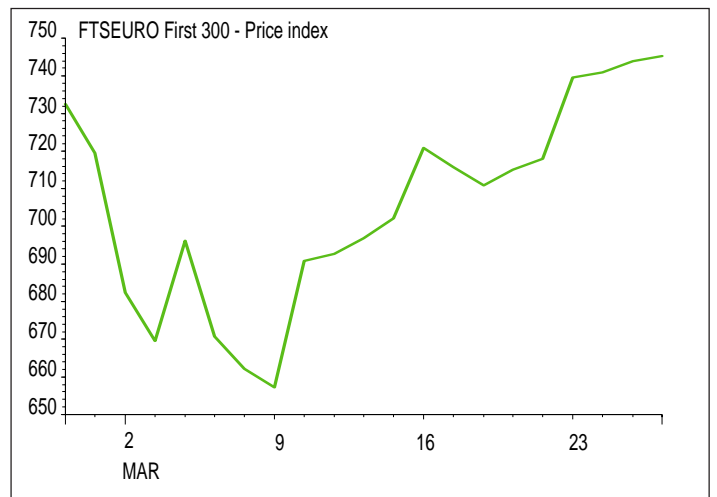
**Chart 4: Dow Jones rose for the third consecutive week**



**Chart 5: Nikkei closed up 8.6%**



**Chart 6: European stocks tracked other indices higher**



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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