



Financial Markets Review

30 October 2009

Strong US GDP insufficient to halt equity market decline

The pound bounced back this week as UK/EZ interest rate spreads turned positive, supporting GBP/EUR

Financial market review - foreign exchange

The pound has recovered this week, becoming the second best performing currency in the G-10 space, just behind the Japanese yen. GBP/USD closed the week 0.8% higher at \$1.6467 and GBP/EUR ended at a five week high. Economic data have been relatively light in the UK and their mixed outcome (a further drop in consumer credit alongside a rise in both mortgage approvals and Nationwide house prices) had little discernable impact on sterling. UK/EZ interest rate spreads (based on 2-year interest rate swaps) moved in favour of the UK, supporting the rally in GBP/EUR. Additionally, merger and acquisition activity provided sterling positive foreign exchange order flow over the week.

The stronger outturn in the US GDP report led to a short term rally in equities and commodity linked currencies

The US dollar had a relatively strong week, rallying against all G-10 currencies bar the pound and yen. The USD index closed the week 1% higher at 76.2. The rally, so far, is still small (in the context of the move 15% move down from the March 2009 high) and as such, currently appears corrective in nature. US economic data have been somewhat mixed this week. New home sales and consumer confidence both deteriorated slightly. On a positive note, durable goods orders rose by 1% in October and the Chicago PMI rose to 54.2, signalling expansion in the manufacturing sector.

The Norwegian central bank has become the third to begin tightening monetary policy

The third quarter GDP release in the US had the largest impact on the USD and other financial markets. The above market consensus outturn, of 3.5% annualised growth in output over the quarter, triggered a 1% rally in USD/JPY and a 2.25% rally in the S&P500. The strong GDP report also supported commodities and commodity currencies, with AUD/USD receiving a 1.7% boost.

The USD rallied strongly against emerging market currencies as falling equity markets triggered large outflows from emerging markets

The Norwegian central bank became the third, after Israel and Australia, to begin tightening monetary policy. The deposit rate was increased from 1.25% to 1.50%. The rate decision occurred amidst a strong USD rally and as such USD/NOK still ended the day higher, however the krone did outperform against its peer group of commodity currencies (Australian and New Zealand dollars).

€/\$ pulls back below 1.50



Financial market rates, ending Fri. 30 Oct 2009

At 4.30pm 30 Oct 09		Change from 23 Oct 09 % change
FTSE 100	5024.43	-4.16%
Exchange rates		
US\$/UK£	1.6467	+0.80%
Euro €UK£	1.1172	+2.62%
Euro €US\$	1.4741	-1.77%
Swaps - 5 year (mid) basis points		
UK pound	3.25	-5.0
US dollar	2.68	-10.0
Euro	2.76	-8.0
Bond yields - 10 year		
UK	3.63	-4.0
US	3.41	-5.0
Euro	3.23	-12.0

The Reserve Bank of New Zealand left the official cash rate (OCR), unchanged, at 2.50%. The bank also noted that the OCR is expected to remain at the current level until the second half of 2010. This surprised market participants, who had begun to expect an earlier increase, given the recent hike by Australia. Hence, the news weighed on the New Zealand dollar, triggering a sharp rally in AUD/NZD.

Across emerging markets, the USD appreciated against most currencies. The Hungarian forint and the South African rand were the weakest currencies, losing 4.5% and 4.6% respectively. The fall in commodities throughout the week (the CRB is nearly 3% lower) weighed heavily on the rand. India became the latest country to tentatively initiate an exit strategy from exceptionally loose policies. The country's central bank, the Reserve Bank of India, raised the statutory liquidity ratio for commercial banks. USD/INR closed the week 1% higher, at 46.975. Finally, further equity outflows from Brazil, which introduced a new government tax on foreign portfolio flows last week, have weighed on the Brazilian real. The currency fell against the USD, recording its first back-to-back weekly decline since July. USD/BRL closed at 1.7475.

£/\$ heading towards resistance at 1.67



Government bonds and swap markets rallied sharply in the early part of the week in a flight to safety as equity markets sold off. Initially boosted by a large drop in US consumer confidence, fixed income markets pared back some of their earlier gains following a stronger-than-expected US GDP report.

2009/10 calendar of central bank meetings

European ECB (1.00%)
 5 November, 3 December, 14 February, 4 March
US FOMC (0-0.25%)
 4 November, 16 December, 27 January, 16 March
UK MPC (0.50%)
 5 November, 10 December, 7 January, 4 February, 4 March

Rolling calendar of UK data releases and events

Manufacturing PMI (2/11)
 Services PMI (4/11)
 Industrial production (5/11)
 NIESR GDP (5/11)
 Producer prices (6/11)
 Trade balance (10/11)
 Official house prices (10/11)

Rolling calendar of US data releases and events

Manufacturing ISM (2/11)
 Factory orders (3/11)
 ADP employment (4/11)
 ISM services (4/11)
 Non-farm productivity (5/11)
 Non-farm payrolls (6/11)
 Average earnings (6/11)

Interest rate market review - bonds, cash and swaps

Government bonds and swap markets rallied sharply in the early part of the week in a flight to safety as equity markets sold off. Financial markets were spooked by a large drop in US consumer confidence, unexpectedly falling to 47.7 from 53.5 (versus expectations of 53.5), especially given the concerns over the sustainability of a recovery following the contraction in UK GDP the week before. The turnaround came on Thursday with the release of US GDP – better than expected and confirming the end of technical recession. US Treasuries pared back some gains with gilts and bunds following, however not quite enough to reverse the full move from the beginning of the week. UK, US and eurozone swap curves all ended the week lower.

Asset market volatility picked up this week driven by concerns over the longer-term outlook for growth and the concern that much of the rally in equity markets has been driven by the excess liquidity generated by loose monetary policy. With Norway and Australia having already raised rates, talk of withdrawing stimulus in other developed countries is picking up. Concerns that the UK is one of the only G10 countries still contemplating further quantitative easing weighed on sterling swap rates and gilt yields this week. Following softer US economic data and equity market weakness on Monday and Tuesday, the sterling 5yr swap rate fell to a low of 3.184% before recovering somewhat by the close of the week. There was little on the UK data calendar this week and much of the trends were led by the US. Thursday, however, saw the final monthly M4 money supply figures revised up to 0.8% versus 0.7% (although excluding OFEs, money supply continues to slow, providing further ammunition for an extra tranche of QE) and a modest pick up in mortgage approvals. The current mindset of the UK consumer was, however, evident in the consumer credit numbers which showed the third consecutive monthly contraction as households pay down debt and rebuild balance sheets. The Bank of England completed the final purchases of the APF scheme this week and attention turns to next weeks MPC meeting where consensus currently expects further QE to be announced.

Attention was heavily focused on the US this week with a raft of economic data. Consumer confidence surprised to the downside, falling for the second consecutive month. The outturn sparked a rally in Treasuries with the 10yr benchmark yield declining 10bps following the report and another 5bps the following day as market

UK 5y swap rate drifting lower



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Altaz Dagha, Economist

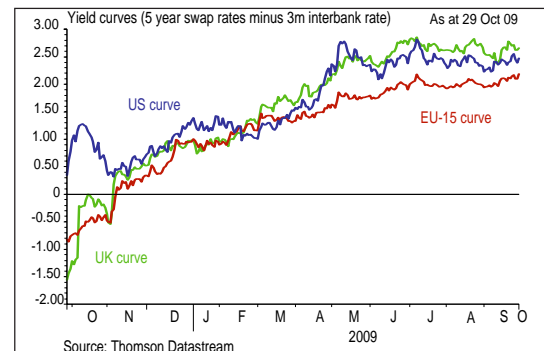
£/€ pushes through last week's high



participants shifted out of equities into government bonds. Given the surprising Q3 UK GDP decline last week, expectation of a similar downside surprise in the US escalated, boosting Treasuries. In the end, annualised GDP for Q3 came in at 3.5%, stronger than expected and confirming the end of the longest stretch of quarterly declines since records began. Boosted by government stimulus measures, personal consumption rose by 3.4%, contributing 2.36pp to the overall growth rate (mainly as a result of the clash-for-clunkers programme). The resulting back up in yields (the 5yr US swap touched 2.8% from a low of 2.65%) reversed much of the earlier move. On Friday, yields began to head back down despite encouraging Chicago PMI and University Of Michigan confidence survey reports. The Chicago PMI jumped to 54.2 from 46.1, more than reversing the previous month's fall while Michigan confidence was revised higher. The market instead focused on the first fall in personal spending (-0.5%) in five months. The US swap curve experienced a sharp bullish steepening move over the week as the market positions for a busy week next week, which includes the FOMC interest rate decision, ISM reports and nonfarm payrolls.

In the eurozone, M3 money supply data for September revealed a further slow down in the rate of money supply growth, although data for the week overall were mixed. In Germany, retail sales contracted by 0.5% in September, however there were encouraging data from the labour market, where there was a further fall in the unemployment rate to 8.1%. Swap yields mainly followed the US throughout the week, although there was slight outperformance in the eurozone on the back of comments from ECB member Weber, who suggested that an exit strategy from the credit easing measures in place will soon be announced.

UK yield curve flattens ahead of MPC meeting



Foreign exchange - graphical analysis of recent trends

Chart 1: £/\$ heading towards resistance at 1.67

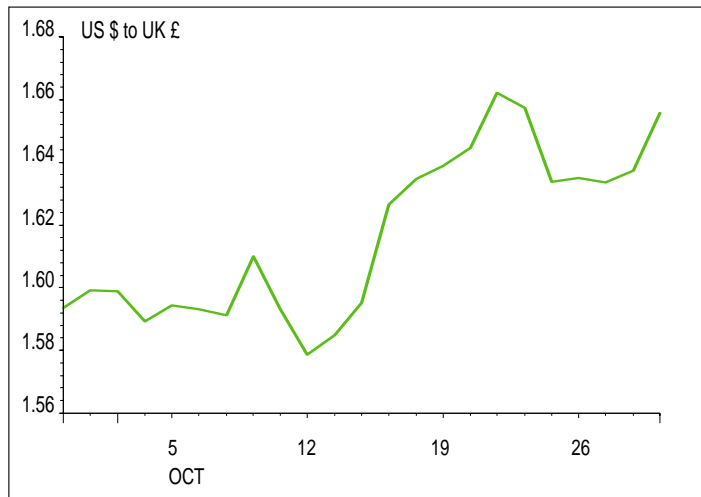


Chart 2: €/€\$ dips back below 1.50

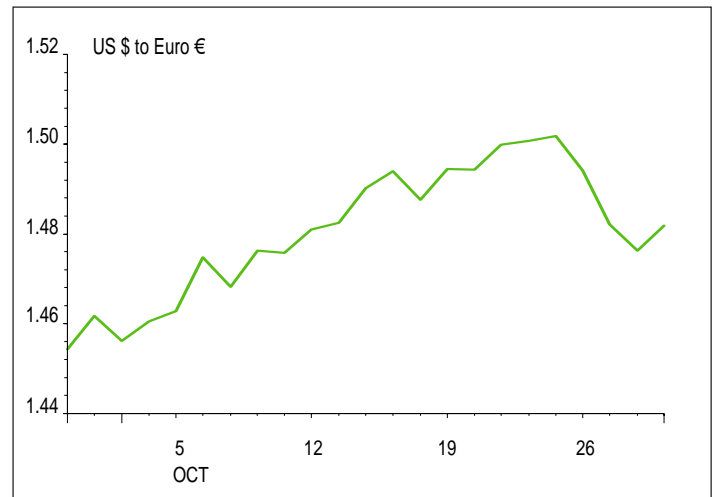


Chart 3: £/€ gains upward momentum

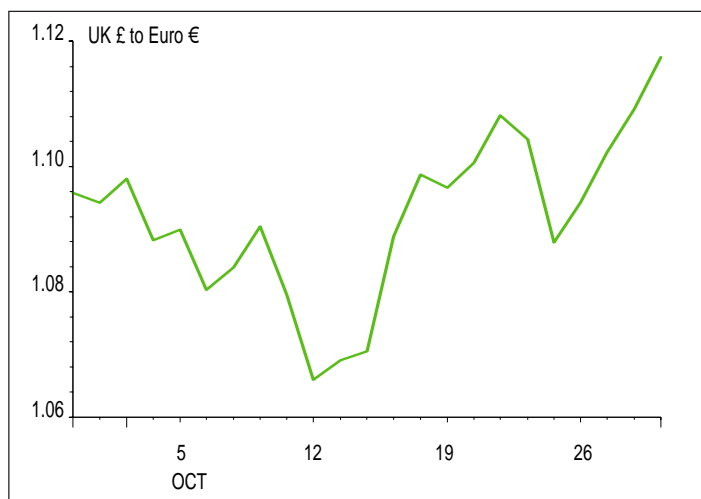


Chart 4: \$/¥ struggling above 92

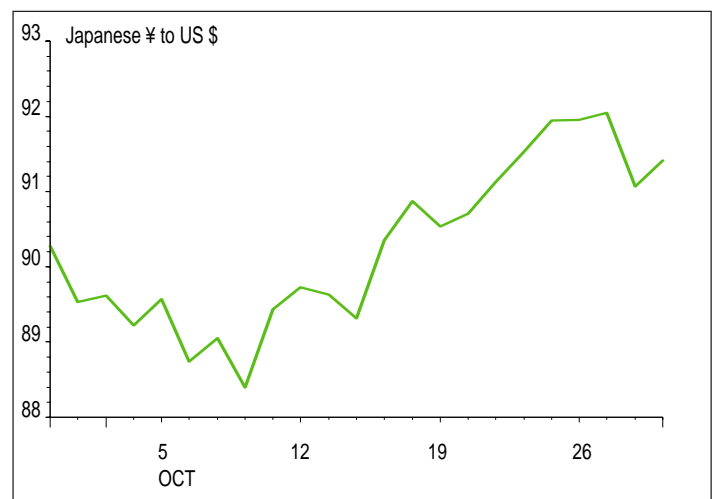


Chart 5: \$/C\$ rallies as commodity prices fall

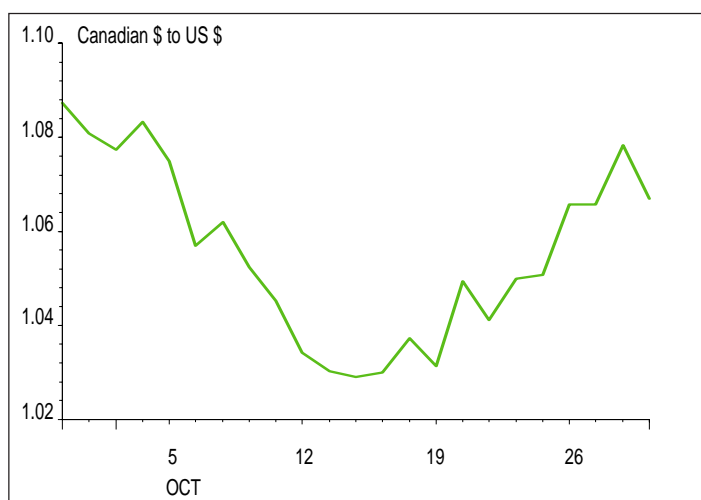
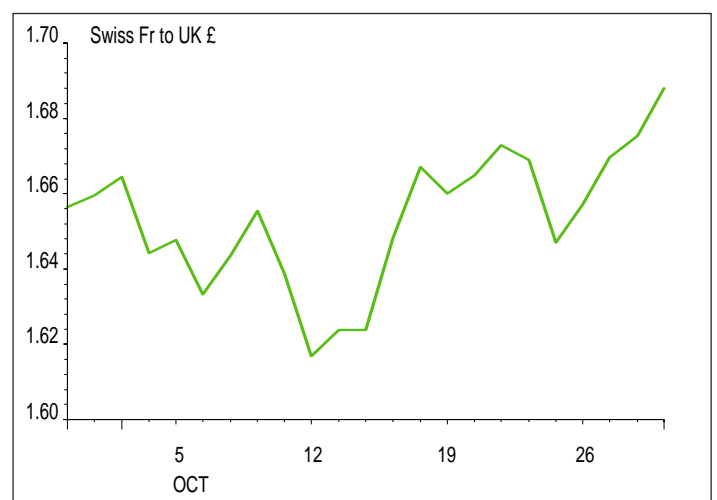


Chart 6: £/CHF pushes towards 1.70



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Fixed income - graphical analysis of recent trends

Chart 1: UK 2yr yield

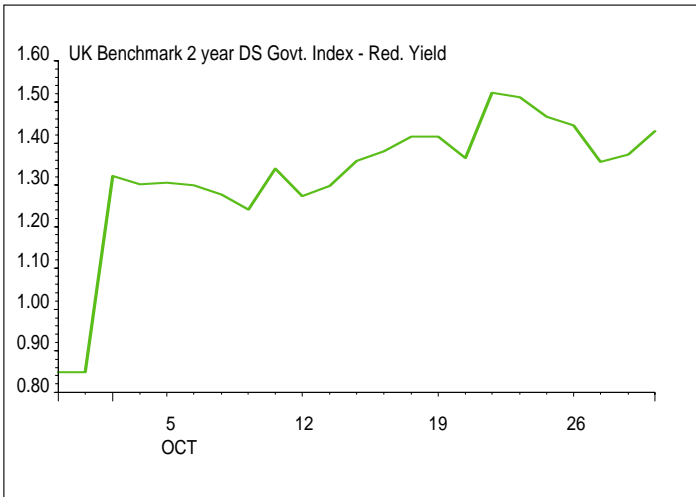


Chart 2: UK 10yr yield

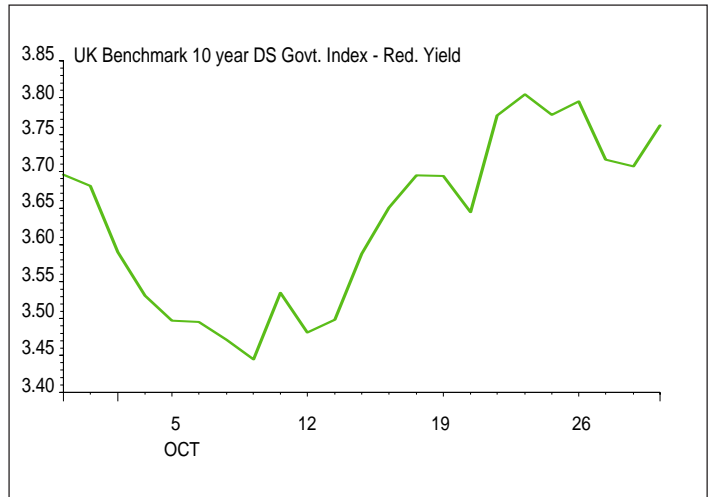


Chart 3: US 2yr yield

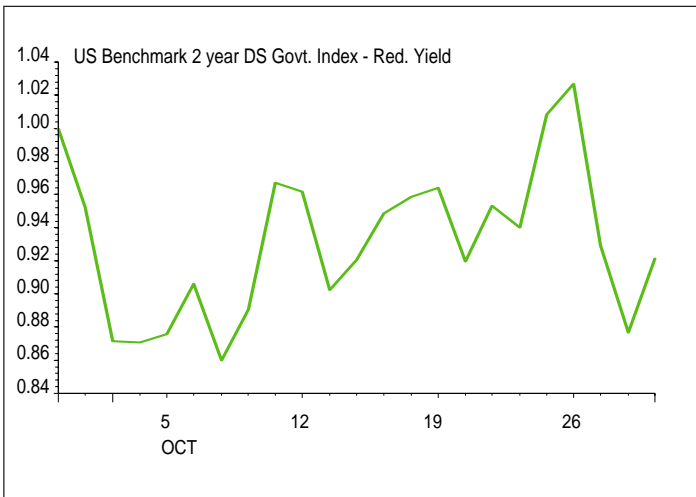


Chart 4: US 10yr yield

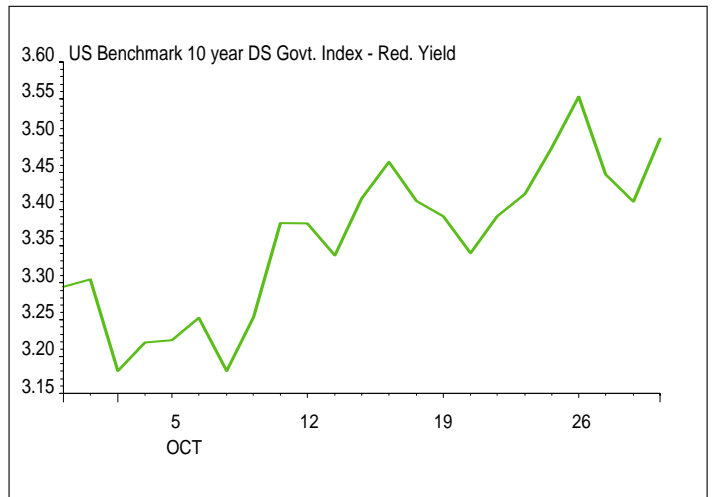


Chart 5: EU-16 2y yields

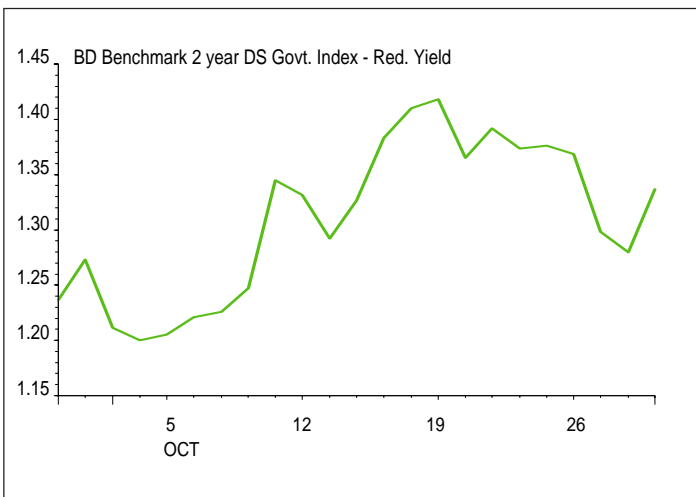
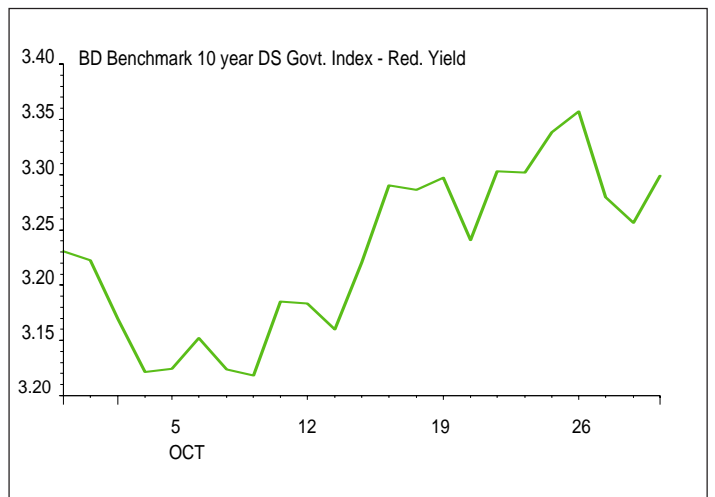


Chart 6: EU-16 10yr yield



Source: *Lloyds TSB Corporate Markets Economics and Thomson Datastream*

Interest rate markets - graphical analysis of recent trends

Chart 1: US 5yr swap



Chart 2: Euro 5yr swap

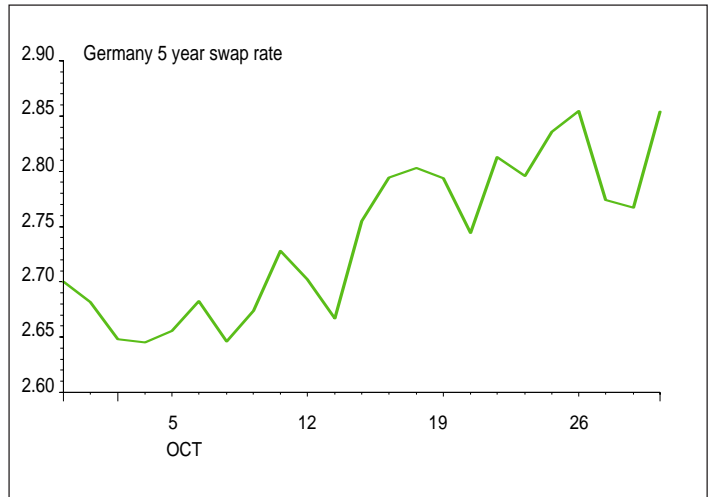


Chart 3: UK 5yr swap



Chart 4: US curve

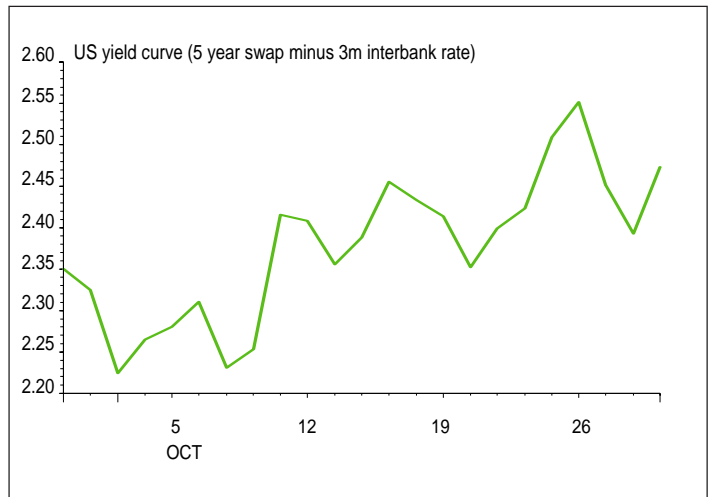


Chart 5: Eurozone spread

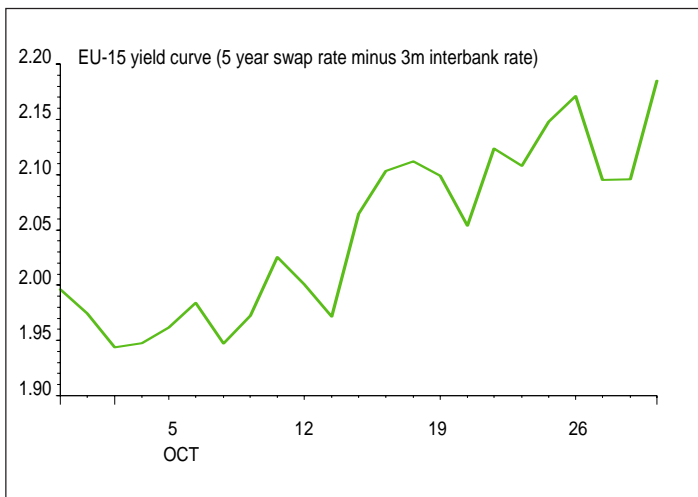
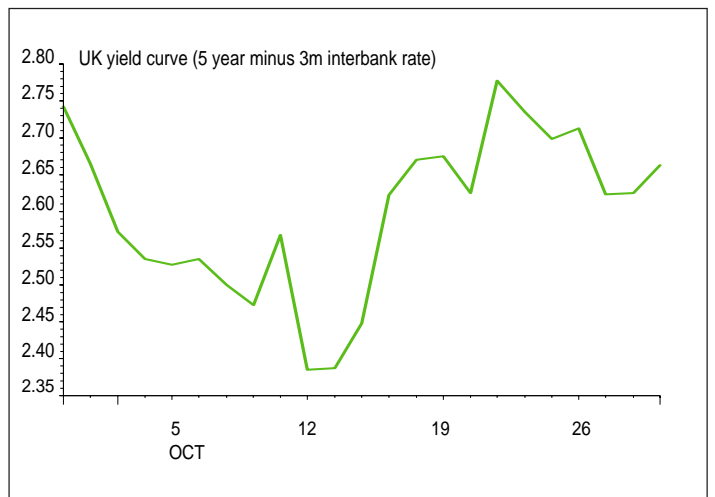


Chart 6: UK curve



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Key commodity and equity markets - Graphical analysis of recent trends

Chart 1: Gold consolidating above 1000

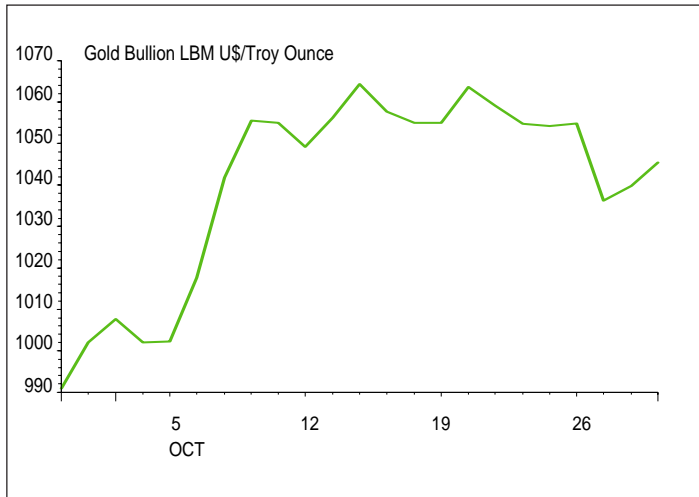


Chart 2: Brent crude oil facing resistance around 78

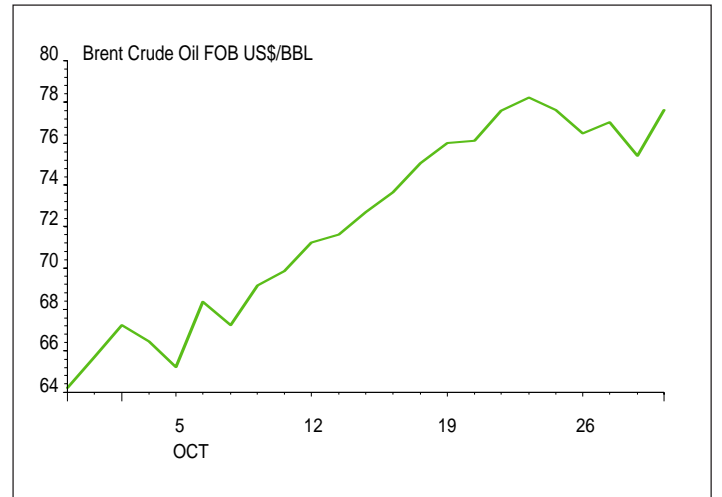


Chart 3: The FTSE-100 losing upward momentum

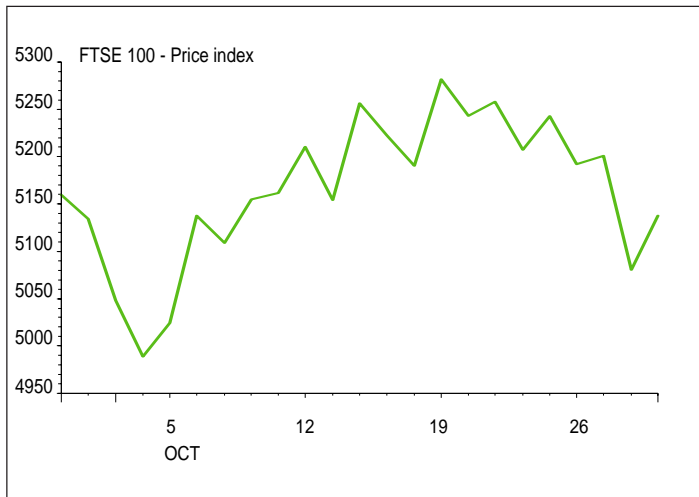


Chart 4: The Dow Jones back below 1,000

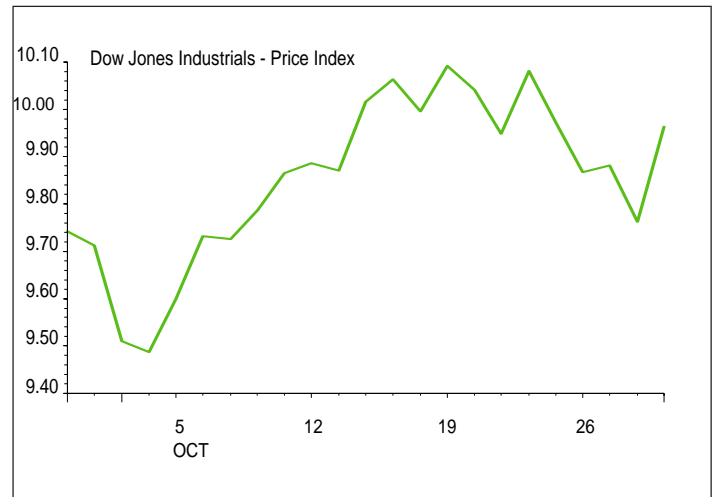


Chart 5: Nikkei under pressure this week

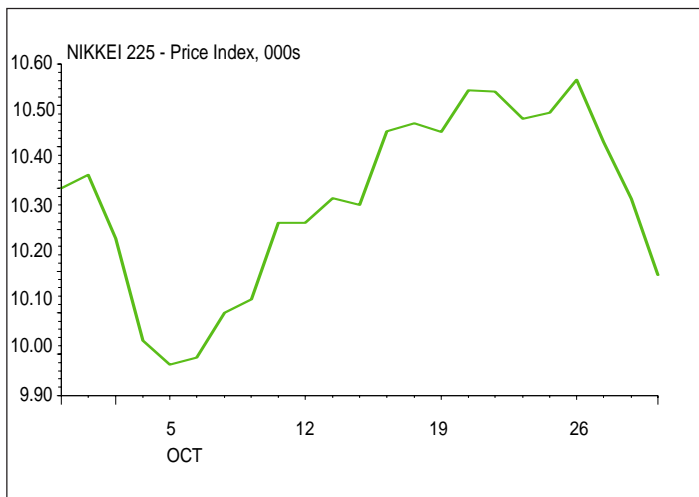
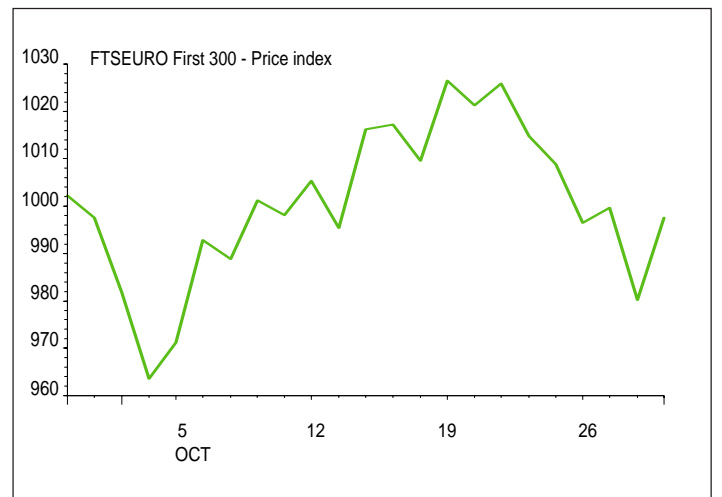


Chart 6: EuroFirst 300 closes the month softly



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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