



# Financial Markets Review

19 February 2010

## Sterling hit by higher UK public borrowing

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In the US, the US dollar index hit its highest level since June 2009, reaching 81.34 following strong economic data and the decision by the Fed to raise the discount rate

In emerging markets, Latin America outperformed with the Brazilian real gaining 2.67% against the US dollar, while the Mexican peso was up 0.83%

### Financial market review - foreign exchange

Sterling broke through key support levels this week, breaking lower out of its recent medium-term range and falling to a nine-month low versus the US dollar. Unexpectedly weak UK labour market data and higher than forecast UK January public borrowing sent GBP/USD below 1.55. The US dollar was given an added boost by the Fed's decision to raise the discount rate to 0.75%, also resulting in a nine-month low for EUR/USD which briefly traded below 1.35. The Australian dollar outperformed in the G-10 space over the week, gaining 0.8% versus the US dollar while EUR/GBP also ended the week higher, up 0.8% at 0.8771.

GBP/USD began the week fairly quietly, ranging between 1.56-1.57, little changed in the scheme of things following the UK CPI report and the release of the latest MPC minutes. Headline CPI inflation rose from 2.9% to 3.5%, triggering a letter from BoE governor King to the Chancellor. Although the rise was as expected and mainly down to base effects following the VAT hike, GBP/USD rose to an intra-week high of 1.58. The MPC have noted that they expect a further spike in inflation and that short-term volatility must be looked through. The minutes revealed a unanimous vote to pause the quantitative easing programme but it was made clear that for some members, the decision was "finely balanced" and that further asset purchases were not ruled out should conditions warrant. It was the surprise increase in jobless claims following two months of falls that kicked off the sterling sell-off on Wednesday. This was compounded by the public sector borrowing numbers which revealed a borrowing of £4.3bn in January, a month which has always previously produced a cash surplus. The report brought to the fore the worrying state of UK public finances and sent sterling tumbling. GPB/USD hit a low of 1.5357 before consolidating just above 1.54.

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### €/ \$ approaching 1.35



### Financial market rates, ending Fri. 19 Feb 2010

At 5pm, 19 Feb 10	Change from 12 Feb 10	
<b>FTSE 100</b>	<b>5358.17</b>	<b>+4.19%</b>
<b>Exchange rates</b>		
US\$/UK£	1.5441	-1.45%
Euro €/UK£	1.1404	-0.81%
Euro €/US\$	1.3538	-0.67%
<b>Swaps - 5 year (mid)</b>		
		<b>basis points</b>
UK pound	3.07	+2.0
US dollar	2.81	+15.0
Euro	2.58	+6.0
<b>Bond yields - 10 year</b>		
UK	4.17	+13.0
US	3.80	+12.0
Euro	3.28	+9.0

rate (although it stressed this is not a shift in monetary policy but rather a normalisation of liquidity measures). Empire manufacturing, housing starts and industrial production all came in above expectations, reinvigorating the view that the US recovery is more robust, especially in comparison to the eurozone and the UK. Widening US/G10 interest rate differentials led to gains across most of the G-10 currencies with the exception of the Australian dollar (up 0.96% to 0.8963) and the Canadian dollar (up 0.82% at 1.0418).

The euro continued to be hampered by ongoing concerns over Greece and the lack of details from the EU about what support Greece may receive should confidence in Greek debt disappear. The rally in equities over the week was not enough to support the euro which sold off to an intra-week low of 1.3444 versus the US dollar before ending the week back above 1.35 at 1.3538. EUR/GBP, however, managed to gain 0.98%.

In emerging markets, Latin America outperformed with the Brazilian real gaining 2.67% against the US dollar, while the Mexican peso was up 0.83%.

### £/\$ through support at 1.55



UK government bond yields rose for a 2nd week in succession as worries over rising UK public debt intensified. Stronger US economic data and resilience in equities and commodity prices also weighed on fixed income securities. Markets equally reacted negatively to the decision by the Fed to raise the discount rate to 0.75%. This does however not change the outlook for US monetary policy for which the Fed funds rates is the main anchor. Gilts underperformed treasuries and bunds for a second week following dreadful January data for UK public finances. UK 10y swaps broke through 4.0%, pushing the spread with 2y swaps out to 237bp.

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

The apathy in the gilt market to weaker UK economic data is striking these days as global market participants focus instead on the deteriorating profile of UK public finances and the consequences of the BoE's decision to pause QE two weeks ago. UK labour market, retail sales and mortgage lending data for January all surprised to the downside but failed to ignite a safe haven bid in gilts (lower yields). The claimant count rate rose in January by 23,500, the biggest rise in 6 months. Retail sales fell by 1.2% m/m, posting the steepest decline in 11 months. The data underline the fragility of the recovery and will keep speculation alive that the BoE may be forced to resume gilt purchases, especially if gilt yields continue to rise at the speed they have since the MPC voted to pause asset purchases in early February. Since the MPC's decision to pause QE, 10y gilt yields have surged 25bp to 4.17%. 15y paper has soared 29bp to 4.67%. The biggest change has been recorded for 20y yields: +32bp to 4.74%. The result is a sharp decline in swap spreads, led by the 10y sector to -18bp. The MPC minutes this week revealed that the Bank voted 9-0 in favour of keeping asset purchases at £200bn. This added to the upward pressure on yields, with weakness in sterling - GBP/USD fell below 1.55 this week and Brent crude rose back over \$75 - stoking inflation concerns. UK January CPI was in line with forecasts, climbing to 3.5% vs 2.9% in December. RPI rose to 3.7%.

A very quiet week for corporate sterling issuance saw only one deal brought to market. KfW issued £600mn of 2013 paper. The DMO's £400mn 2047, RPI linked gilt auction was covered 2.23 times. US

## £/€ remains range bound



Treasuries struggled against the tide of rising yields virtually all week following hawkish comments by FOMC member Plosser and stronger than expected economic data including industrial output, the Philly Fed and PPI. Though the Fed reassured that a rise in the discount rate does not signal a change in monetary policy, treasuries still sold off and yield rose, led by the long end. The 2y/10y curve steepened to a new high over 290bp, before settling at 288bp following weaker than expected January CPI data on Friday. Core CPI unexpectedly fell 0.1% m/m, lowering the annual rate to 1.6% from 1.8% previously, the lowest in 4 months. Separately, the Treasury announced it will sell \$126bn in coupons next week. Finally, yields were also pressured higher by evidence of that China's holdings of treasuries fell back to \$755.4bn in December, though some of the decline has been attributed to the maturing of some individual holdings, and China has continued to purchase shorter-dated Treasury bills. US 5y swaps shot up 15bp this week to 2.81%, a one-month high. Nationwide Building Society raised \$1.5bn in dollar paper this week, split between 5y and 10y notes. Total US corporate bond sales fell back to only \$3.8bn this week, the lowest for the year, despite a marginal tightening in investment grade spreads.

EU bunds followed yields higher with the 2y/10y curve steepening up to 220bp. 5y swaps rose 6bp to 2.58%. Data from Germany showed a decline in the ZEW index to 45.1 in February from 47.2 in January. The services PMI fell back to 51.7 but the manufacturing PMI surged to 57.1. The 10y Greek/bund spread ended the week 23bp wider at 318bp.

### 2010 calendar of central bank meetings

#### European ECB (1.00%)

4 March, 8 April, 6 May, 10 June, 8 July

#### US FOMC (0-0.25%)

16 March, 28 April, 23 June

#### UK MPC (0.50%)

4 March, 8 April, 6 May, 10 June, 6 July

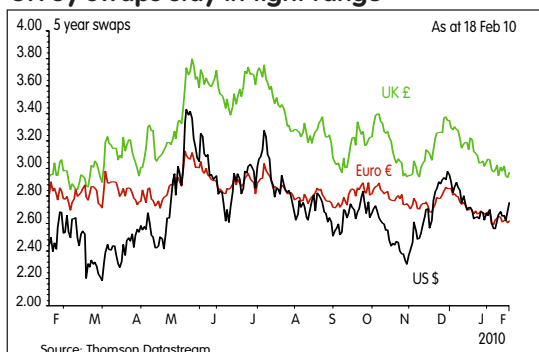
### Rolling calendar of UK data releases and events

GfK consumer conf. (26/02)  
Q4 GDP (26/02)  
Mortgage approvals (01/03)  
PMI manufacturing (01/03)  
PMI services (03/03)  
Producer prices (05/03)  
RICS house prices (09/03)  
Trade balance (09/03)  
Industrial production (10/03)

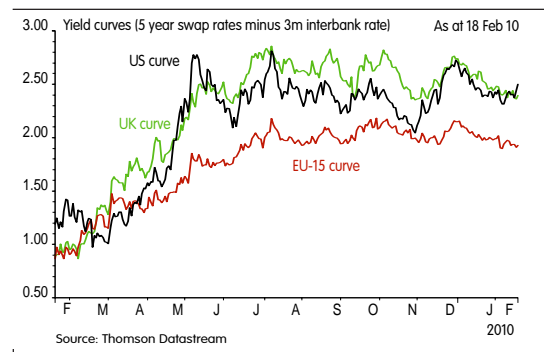
### Rolling calendar of US data releases and events

Consumer conf (23/02)  
New home sales (24/02)  
Durable goods order (25/02)  
Q4 GDP (26/02)  
Existing home sales (26/02)  
Core PCE deflator (01/03)  
ISM manufacturing (01/03)  
ISM non-manu (03/03)  
Factory orders (04/03)

### UK 5y swaps stay in tight range



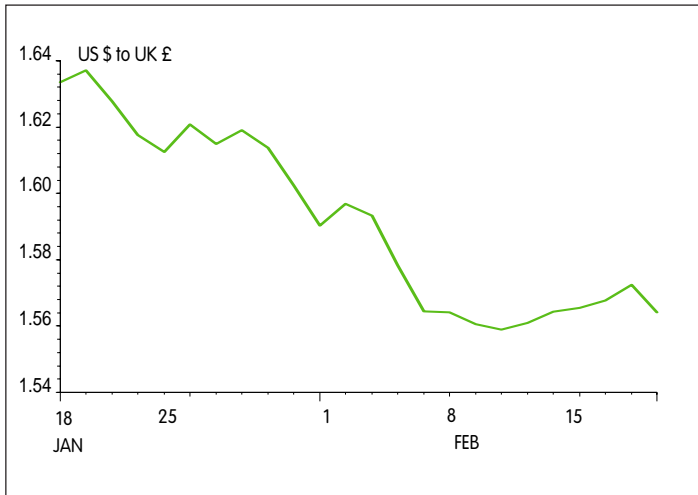
### Yield curves steepened



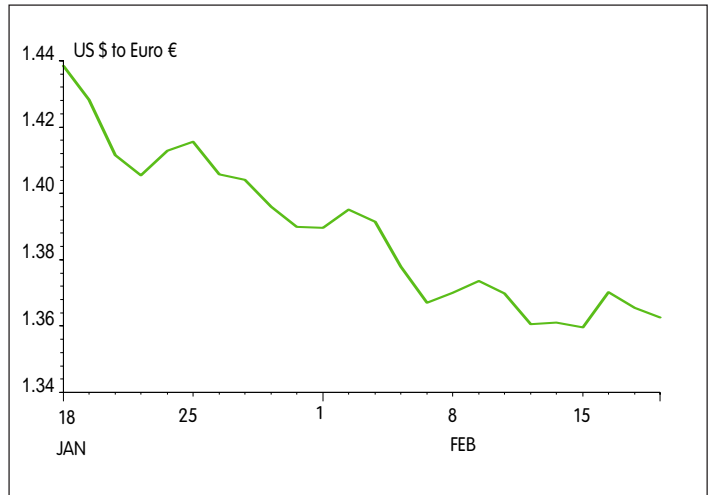
**Kenneth Broux, Senior Market Economist**  
**Altaz Dagher, Strategist**

# Foreign exchange - graphical analysis of recent trends

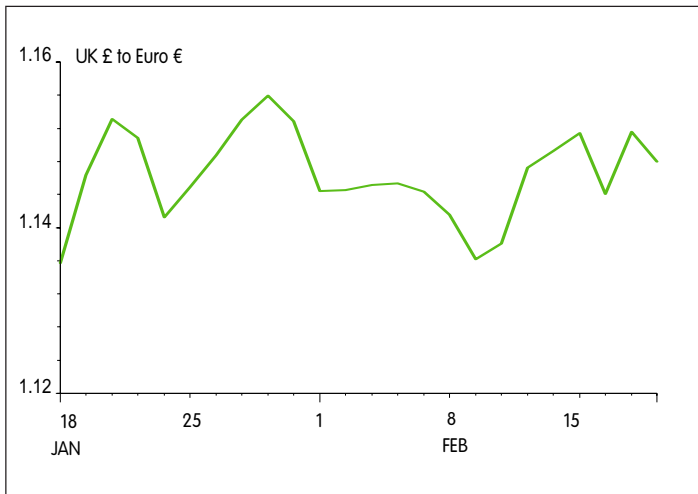
**Chart 1: £/\$ approaching 1.54**



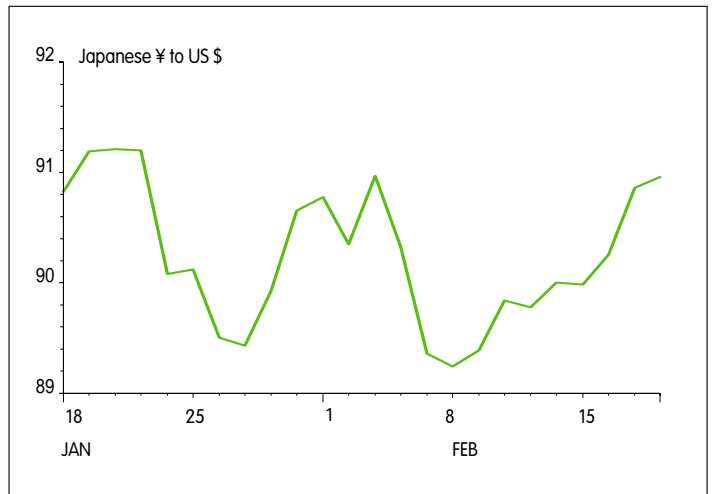
**Chart 2: €/€ breaks below 1.36**



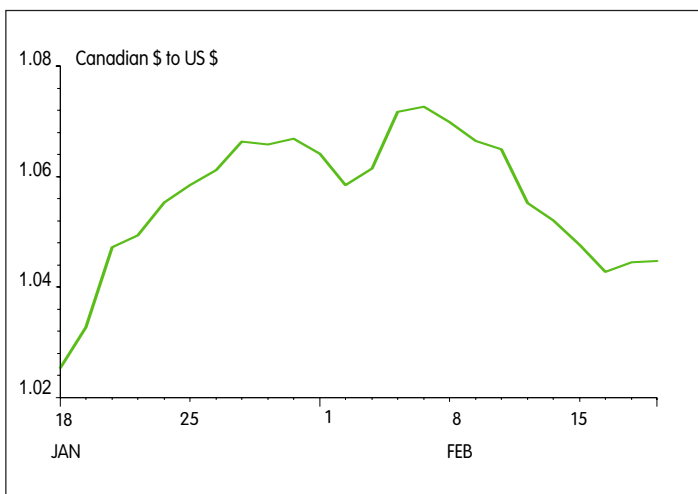
**Chart 3: £/€ failed to move above 1.15**



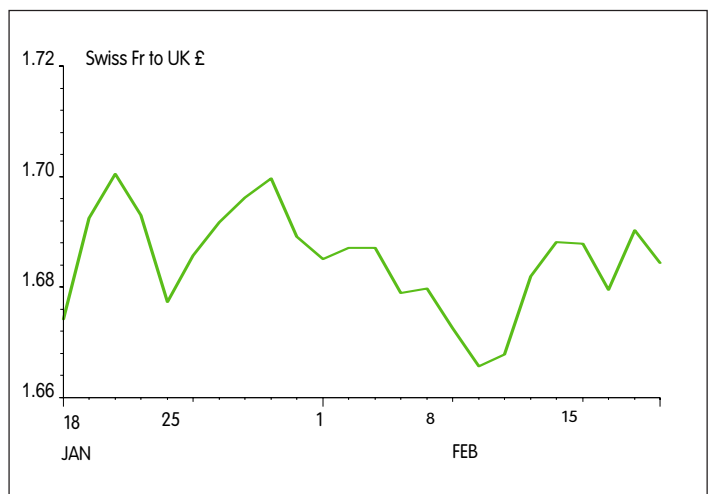
**Chart 4: \$/¥ rallies to 91.0**



**Chart 5: \$/C\$ back below 1.05**



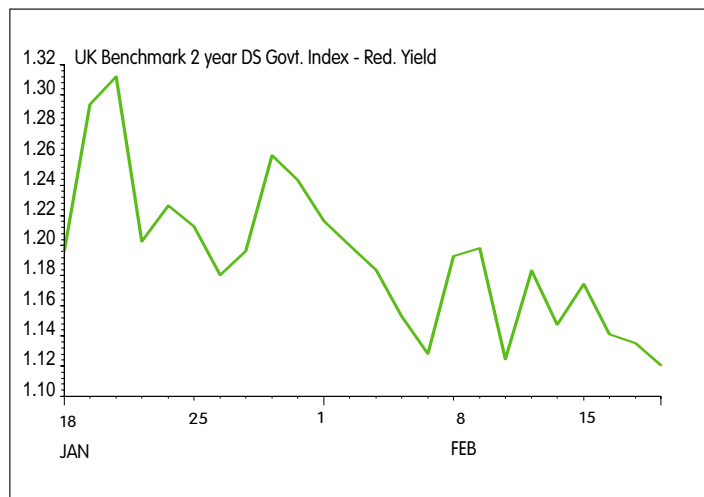
**Chart 6: £/CHF little changed on week**



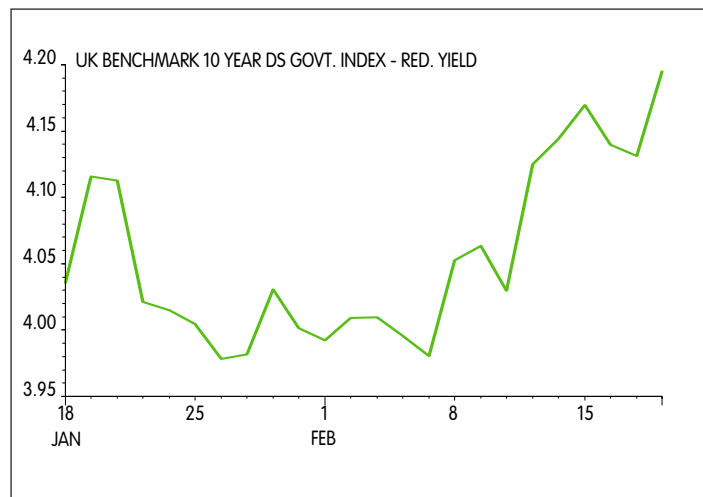
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Fixed income - graphical analysis of recent trends

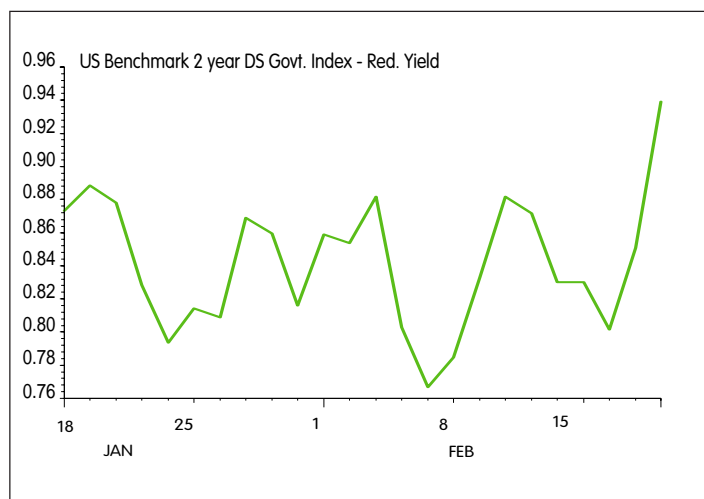
**Chart 1: UK 2yr yields stay near recent low**



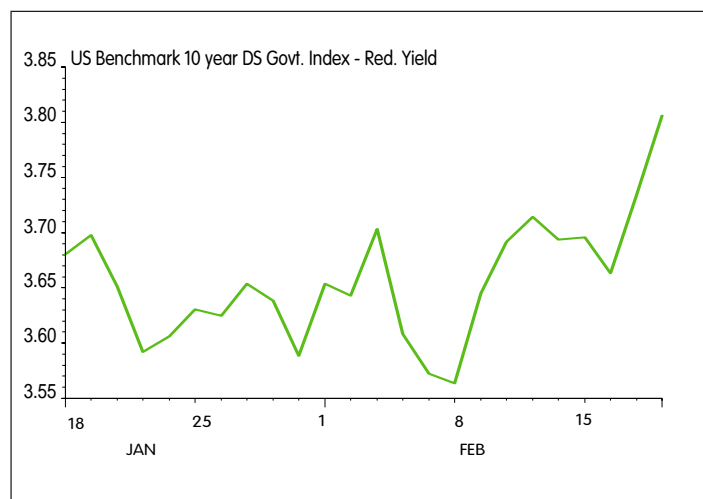
**Chart 2: UK 10yr yield clears 4.10%**



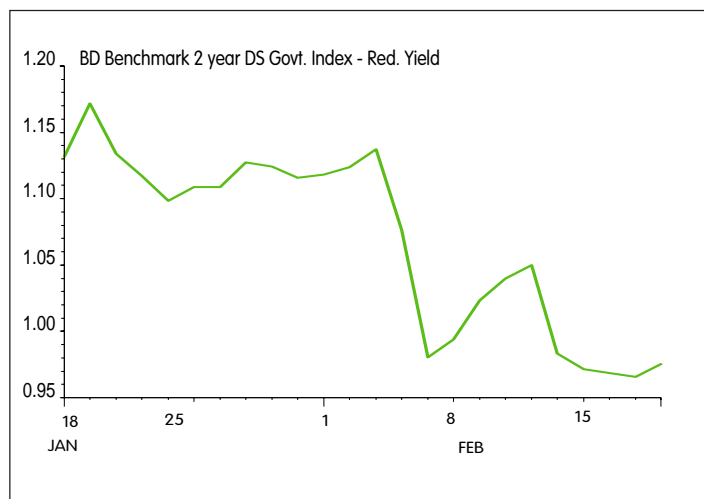
**Chart 3: US 2yr yields shot up on Fed discount rate hike**



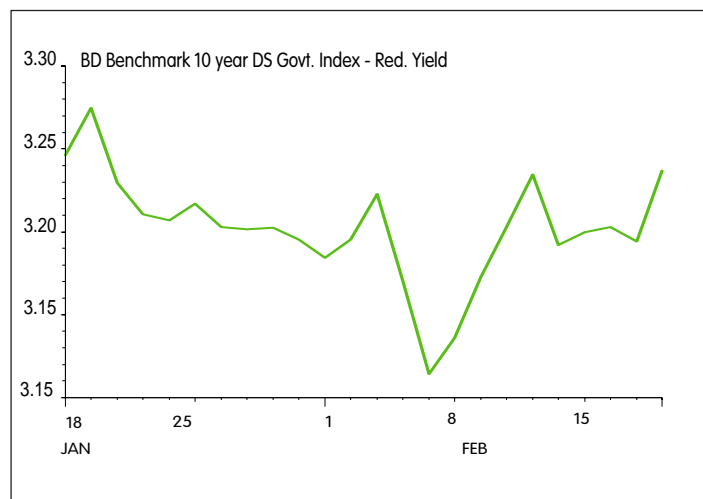
**Chart 4: US 10yr yield reach 3.80%**



**Chart 5: EU-16 2y yield anchored near 1%**



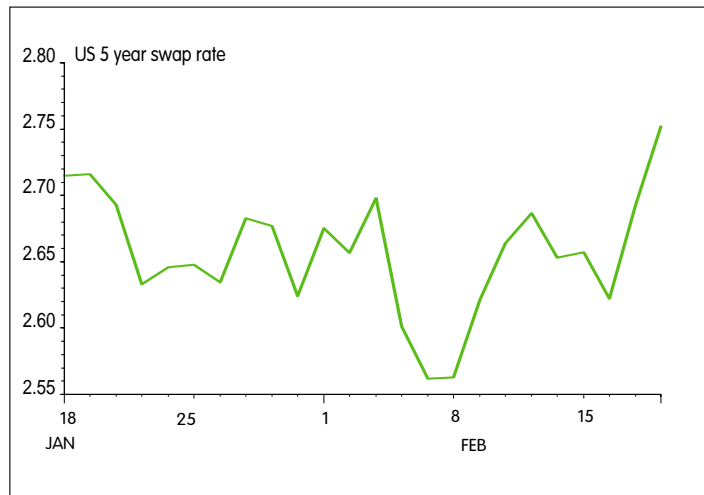
**Chart 6: EU-16 10yr yields at upper end of recent range**



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

# Interest rate markets - graphical analysis of recent trends

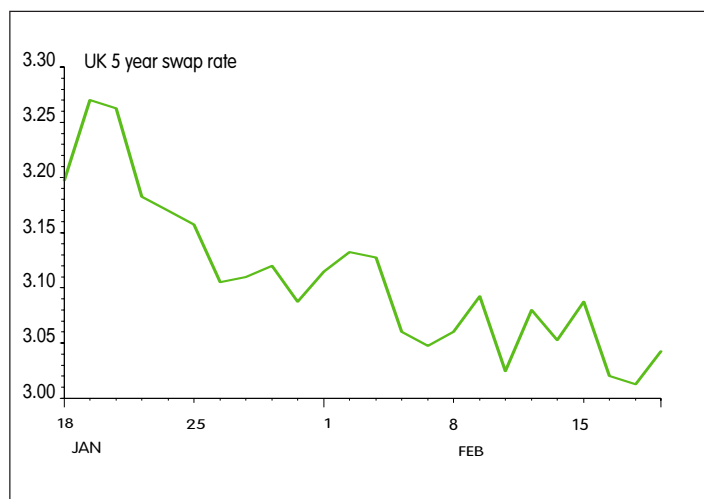
**Chart 1: US 5yr swap extends upward move**



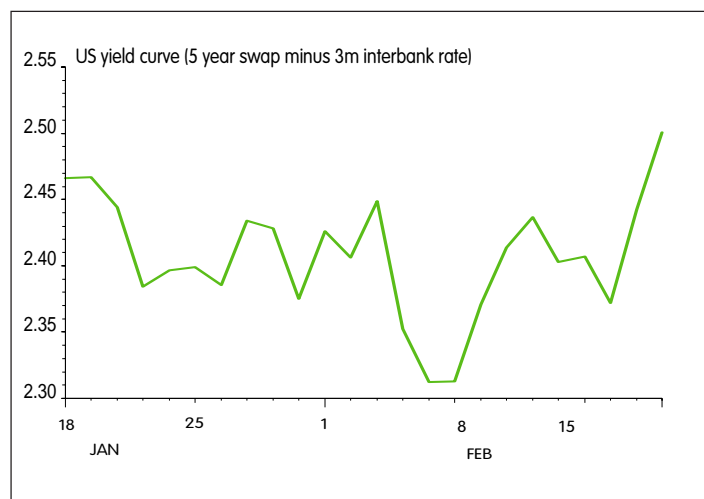
**Chart 2: Euro 5yr swap stable at 2.55%**



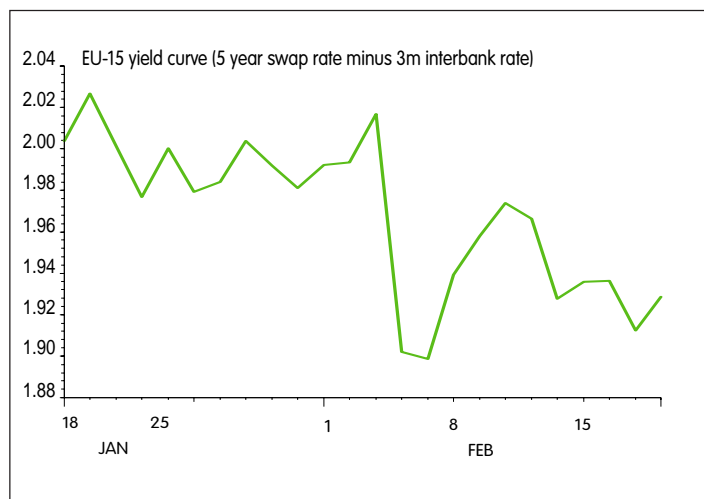
**Chart 3: UK 5yr swap drifts near 3%**



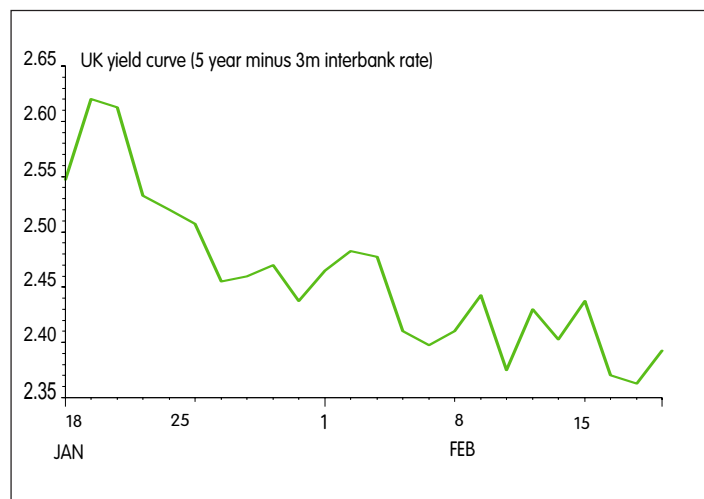
**Chart 4: US curve steepens**



**Chart 5: Eurozone curve spread steady**



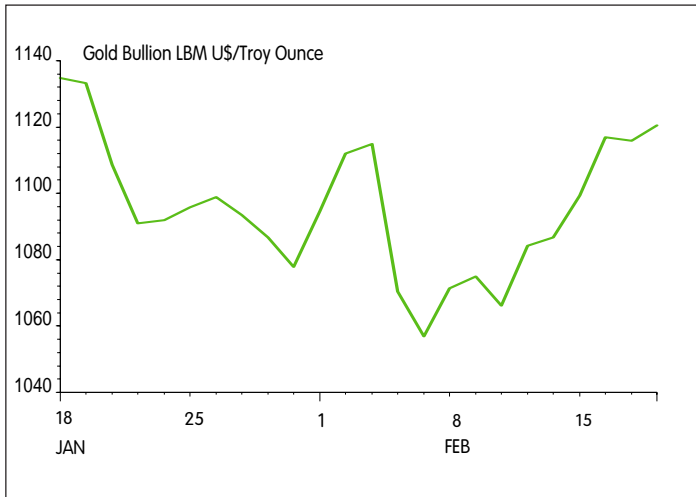
**Chart 6: UK curve spread near recent lows**



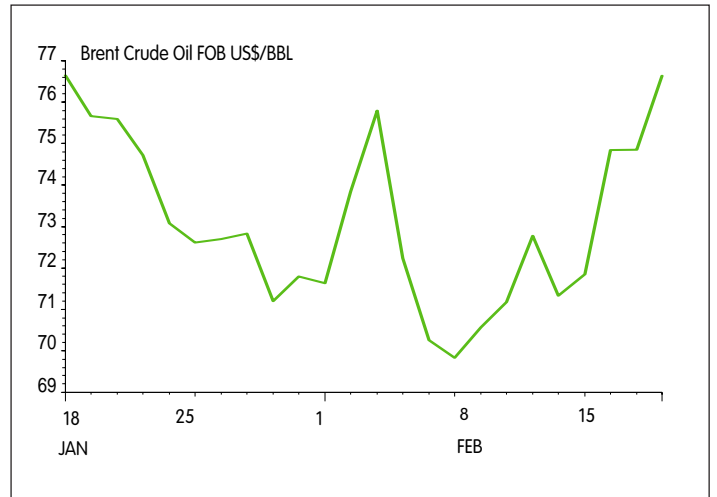
Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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

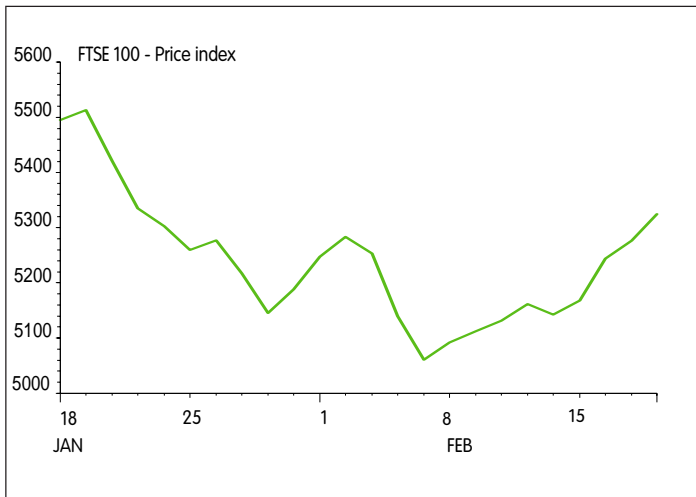
**Chart 1: Gold back at \$1,120**



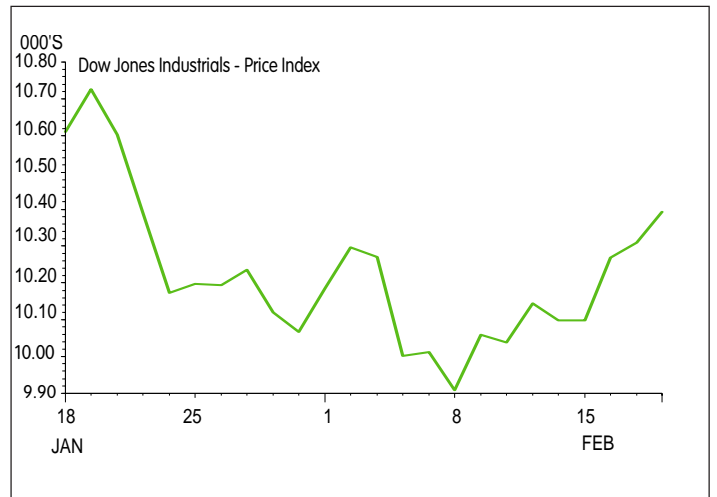
**Chart 2: Brent crude heading back towards \$80**



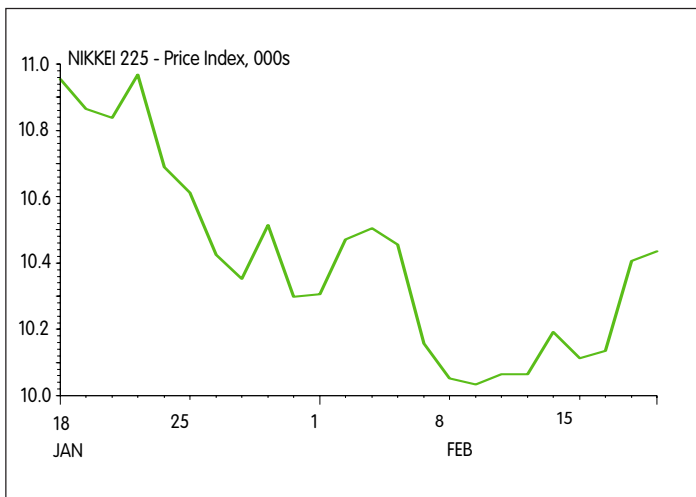
**Chart 3: FTSE-100 rallied to 5,300**



**Chart 4: Dow Jones clearly above 10,000**



**Chart 5: Nikkei at 10,400 resistance**



**Chart 6: EuroFirst 300 back through 1,000**



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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