Lloyds TSB | Corporate Markets

Financial Markets Review

5 February 2010

Sterling falls sharply despite pause in QE

Sterling suffered from heavy selling pressure all week, despite the BoE announcing a pause in quantitative easing, losing ground against all G-10 currencies and breaking below key support versus the USD

Euro weakness has been prominent throughout the week despite the EC endorsing the budget proposals from Greece that are needed to bring the fiscal position under control. Market focus turned to Spain and Portugal.

The Swiss franc continued to appreciate, hitting a high of 1.4558 prompting SNB intervention

The US dollar was one of the main beneficiaries of the sharp deterioration in equities. New cycle lows versus the euro and sterling were posted this week.

Financial market review - foreign exchange

Sterling suffered from heavy selling pressure all week, despite the BoE announcing a pause in quantitative easing. Sterling lost ground against all G-10 currencies and broke below key support versus the USD (1.57008). Risk aversion trades continued with equity markets falling for the third consecutive week while sovereign CDS spreads widened further, particularly in peripheral eurozone countries. EUR/USD fell below 1.37 for the first time since May.

Euro weakness has been prominent despite the EC endorsing the budget proposals from Greece to bring the fiscal position under control. Attention turned, however, to Spain and Portugal. A disappointing Spanish bond auction and a failed bill auction in Portugal led to a widening of spreads with bunds while Spanish and Portuguese stock markets fell 5% in one day. With little in the way of tier one economic data and the ECB unsurprisingly leaving the refinancing rate unchanged at 1%, equity markets were the main FX drivers over the week. In the ECB press conference, Mr. Trichet played down the need for a Greece bailout.

The Swiss franc continued to appreciate, hitting a high of 1.4558 vs the euro before the SNB intervened, pushing the rate immediately through 1.48. EUR/JPY fell sharply over the week, breaking through key support levels around 125 before finding a base around 122.

GBP/USD drifted sideways between 1.59-1.60 ahead of the MPC meeting. The decision to pause QE was pretty much expected by the market, although the door was left open for further asset purchases. Sterling was given a short-lived boost, rallying to 1.6069, before sustained selling pressure and hitting an 8-month low of 1.5630 on Friday. Economic data was mixed throughout the week. Mortgage approvals unexpectedly fell to 59.0k in Dec while the Services PMI also registered a decline to 54.5 from 56.8. The manufacturing survey, however, rose to 56.7 – the highest outturn for fifteen years.

€/$ slides below 1.37

Source: Thomson Datastream

Financial market rates, ending Fri. 5 Feb 2010

At 4.30pm, 5 Feb 10		Change from 29 Jan 10
FTSE 100	5060.92	-2.46%
Exchange rates		
US$/UK£	1.5611	-2.51%
Euro €/UK£	1.1478	-0.55%
Euro €/US$	1.3600	-1.98%
Swaps - 5 year (mid)		**basis points**
UK pound	3.02	-8.0
US dollar	2.59	-10.0
Euro	2.50	-11.0
Bond yields - 10 year		
UK	3.88	-3.0
US	3.57	-7.0
Euro	3.11	-9.0

The US dollar was one of the main beneficiaries of the sharp deterioration in equities. New cycle lows versus the euro and sterling were printed this week. The RBA surprised the markets by not raising official interest rates, sending AUD/USD down to 0.8613, close to its 200 day moving average (0.8578). In recent weeks, the US dollar rally has been primarily led by interest rate differentials due to the improvement in economic data. Over the past week or so, the market has returned to a risk negative/US dollar positive mode. Despite slightly weaker than expected labour market data (non-farm payrolls surprised to the downside while initial jobless claims rose), the DXY US dollar index broke rose nearly 1.5% over the week, breaking above 80 for the first time since July 2009.

The sell-off in emerging market currencies also continued this week as equity markets and commodities dropped sharply. Eastern European currencies were the worst performers (Polish zloty fell 3.1% versus the USD, Hungarian florint was down 3.0%) while the Brazilian real (+0.39%) was the star performer.

£/$ dropped below 1.57

Source: Thomson Datastream

Government bond markets posted impressive gains for a 3rd week in succession as turmoil in equity markets and peripheral euro zone countries triggered a broad based flight-to-quality. This pushed UK 5y swaps below 3% and 2y bund yields below 1%.

2010 calendar of central bank meetings

European ECB (1.00%)
4 March, 8 April, 6 May, 10 June
US FOMC (0-0.25%)
16 March, 28 April, 23 June
UK MPC (0.50%)
4 March, 8 April, 6 May, 10 June

Rolling calendar of UK data releases and events

Trade balance (09/02)
Industrial production (10/02)
BoE Inflation Report (10/02)
CPI inflation (16/02)
BoE MPC minutes (17/02)
Labour market stats (17/02)
Public finances (18/02)
M4 money supply (18/02)
Retail sales (19/02)

Rolling calendar of US data releases and events

Trade balance (10/02)
Retail sales (11/02)
TIC capital flows (16/02)
Housing starts (17/02)
Industrial production (17/02)
FOMC minutes (17/02)
Producer prices (18/02)
Consumer prices (19/02)
Consumer conf (23/02)

Interest rate market review - bonds, cash and swaps

Government bond markets posted impressive gains for a 3rd week in succession as turmoil in equity markets and peripheral euro zone government debt triggered a broad based flight-to-quality, pushing UK 5y swaps below 3% and 2y bund yields below 1%. Falling equities and rising credit spreads caused 2y/10y yield curves to steepen with short dated yields outperforming. A weaker than expected US employment report for January and a fall in crude oil prices below $70pb also dragged yields down and reinforced expectations that central bank interest rates will stay low for a long period, while plans to exit from exceptional liquidity programmes maybe brought into question. UK government supply drew solid demand, but a widening in corporate spreads and falling equities resulted in a reduction of corporate sterling issuance.

The storm raging across the southern euro zone debt markets intensified this week and also saw confidence about Portugese and Spanish sovereign debt evaporate as CDS spreads surged and government bond spreads widened over bunds. The ECB kept its benchmark rate on hold at 1% and played down speculation of intervention, warning the respective countries to get their public finances under control. The 10y Greek yield vs bunds first fell to 330bp as the EU approved Greeces' fiscal consolidation plan, but the spread widened back out to over 350bp by the weekly close. 10y Spain/bund crossed the psychological 100bp barrier. Regional equity market indices posted sharp falls, with the Spanish Ibex losing nearly 10%. Bond yields were also dragged lower by disappointing economic data from Germany, December data for new industry orders and manufacturing output showed sizeable declines, bolstering confidence that interest rates will stay low for some time. Euro zone 5y swaps hit a low of 2.58%, but closed the week 9bp down at 2.60%. The 2y/10y bund spread steepened to 214bp.

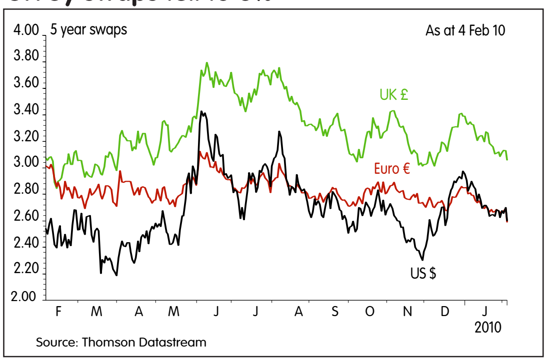
In the UK, the BoE left Bank rate on hold at 0.50% and decided against expanding its asset purchase programme above £200bn. Gilts initially sold off on the verdict but quickly reversed and yields subsequently resumed their path lower as the FTSE

£/€ fell 0.6%, back below 1.15

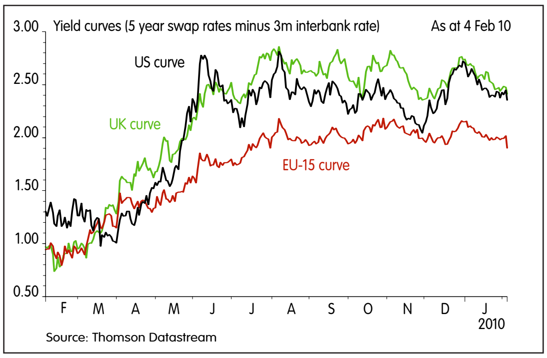
accumulated losses in excess of 2%. 5y swaps broke out of the recent range and fell to 3% to a near two-month low as risk aversion stoked strong receiving interest. Corporate issuance trickled back to just two sterling deals this week, including a £130mn, 2041 issue by South East Water (190bp over gilts) and a £200mn, 2017 issue by Close Bros Group (320bp over). Despite taking place ahead of the BoE decision and uncertainty over additional gilt purchases, the two gilt auctions drew solid bidding interest this week. The £3.75bn, 2012 sale was covered 3.12 times. The £3bn, 20108 auction drew bids worth 1.99 the amount on offer.

Treasuries underperformed gilts and bunds despite similar falls in equity indices and weaker than expected January employment data. Non-farm payrolls dropped by 20,000 last month, but data for December was revised down to -150,000 from -85,000. Data revisions also revealed that an extra 930,000 jobs had been lost last year. The unemployment rate fell to 9.7% from 10.0% thanks to a stronger outturn for a separate employment survey, but was unable to arrest the fall in the Dow to below 10,000. US 2y yields fell below 0.80% to the lowest level since mid-December. 5y swaps dropped 11bp to 2.59%. Kraft was among the largest dollar issuers this week, raising a total of 8.5bn, split between 2016, 2020 and 2040 paper. The FOMC minutes will keep the market on alert next week for any sign of divergence on monetary policy. The Treasury will sell $81bn in its quarterly refunding, with the bulk of supply earmarked for 3y notes ($40bn).

UK 5y swaps fell to 3%



Yield curves flattened



Kenneth Broux, Senior Market Economist
Altaz Dagha, Strategist

Foreign exchange - graphical analysis of recent trends

Chart 1: £/$ breaks below 1.57

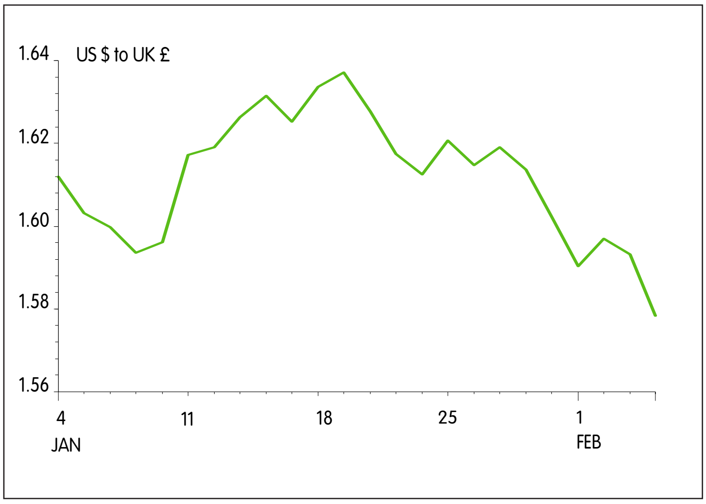


Chart 2: €/$ falls below 1.37

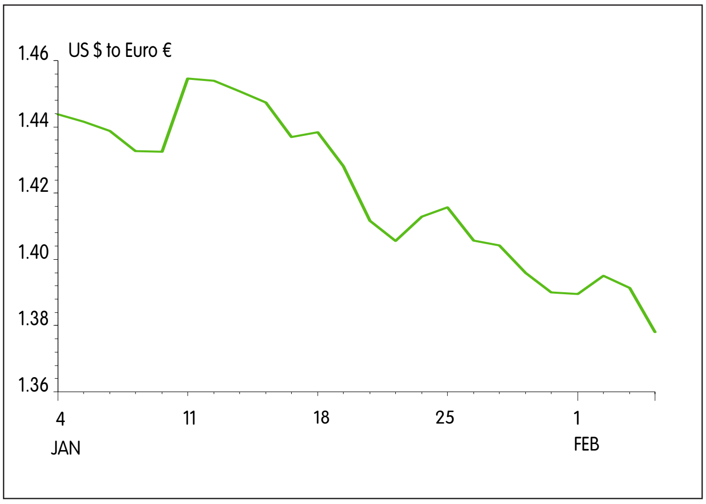


Chart 3: £/€ range bound over the week

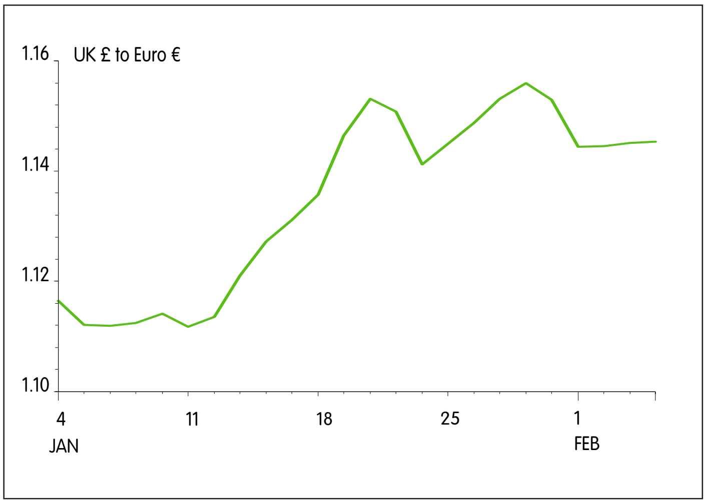


Chart 4: $/¥ stable around 90

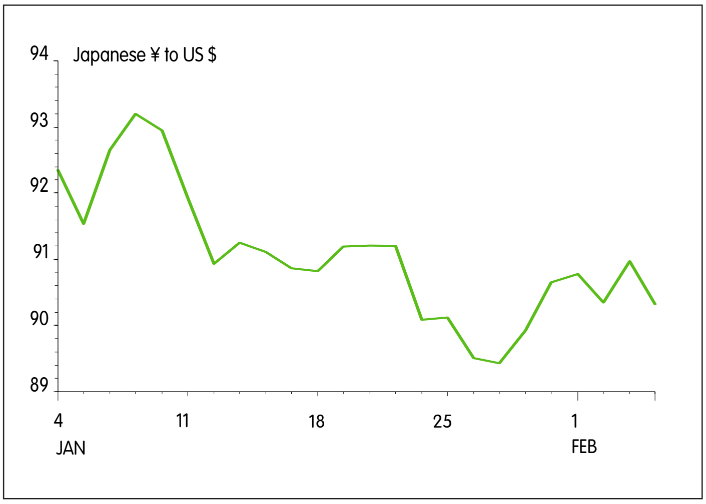


Chart 5: $/C$ targetting 1.08

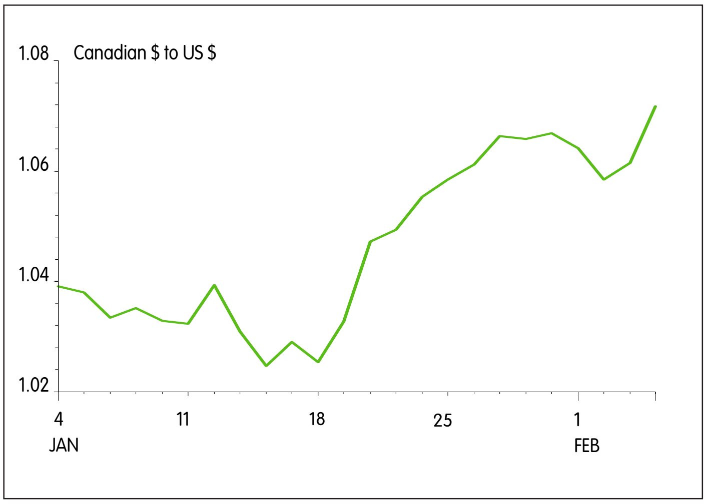
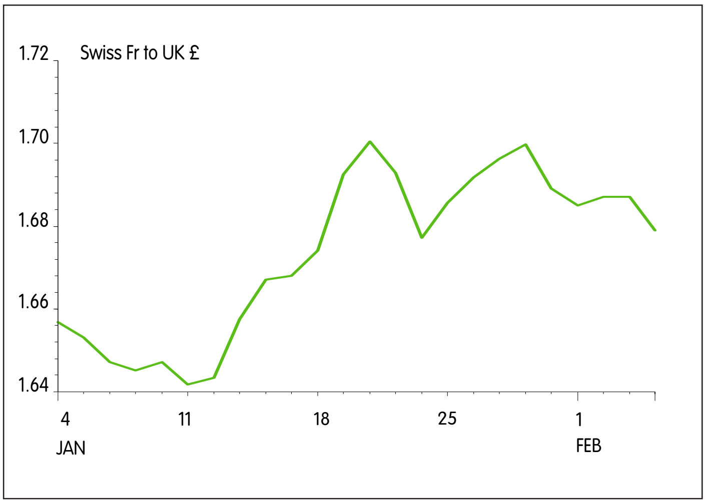


Chart 6: £/CHF failed to break above 1.70



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Fixed income - graphical analysis of recent trends

Chart 1: UK 2yr yields drop to 1.15%

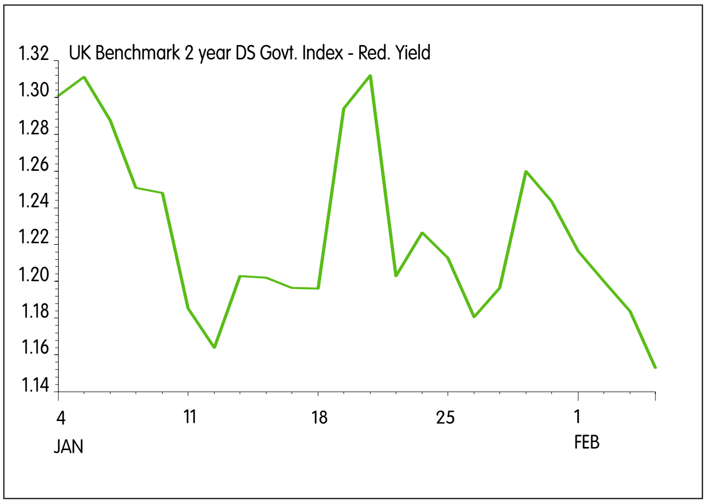


Chart 2: UK 10yr yield steady below 4%

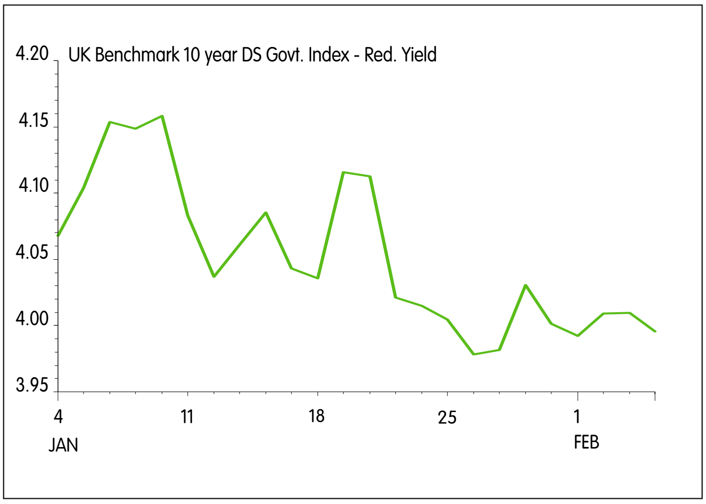


Chart 3: US 2yr yields fall back to 0.80%

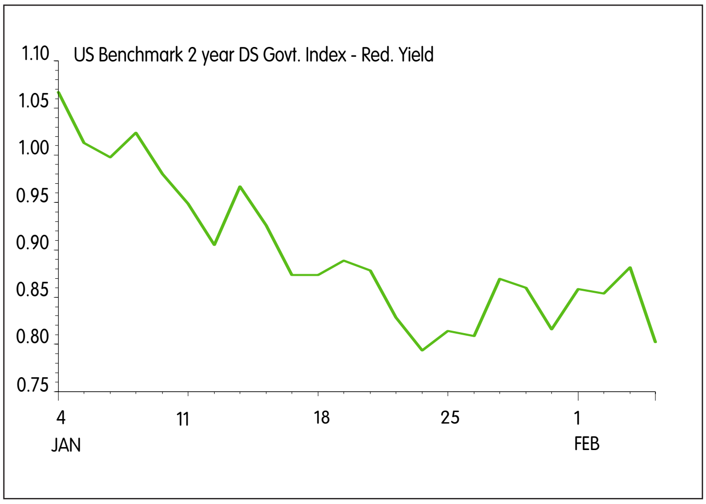


Chart 4: US 10yr yield through 3.60%

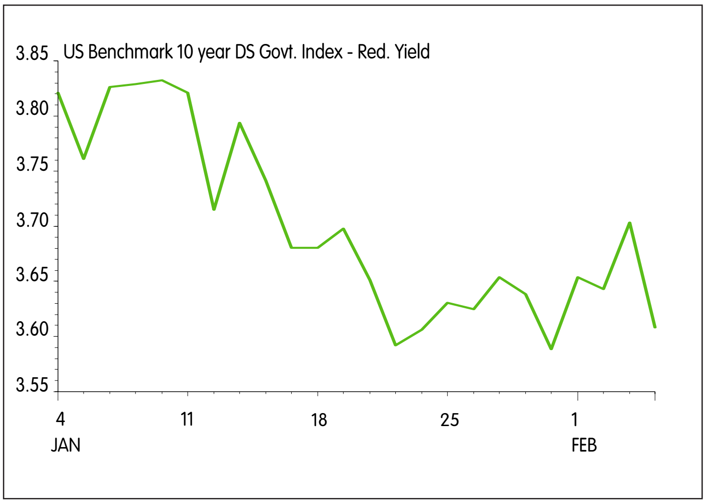


Chart 5: EU-16 2y yield slips to 1.05%

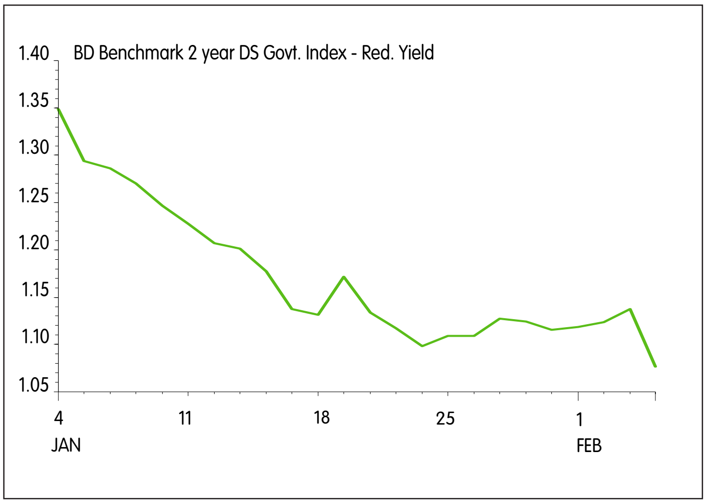
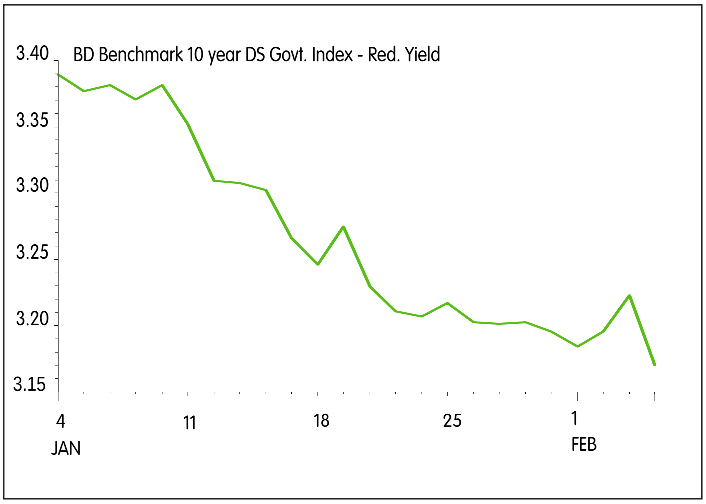


Chart 6: EU-16 10yr yields extends downtrend



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Interest rate markets - graphical analysis of recent trends

Chart 1: US 5yr swap falls to 2.60%

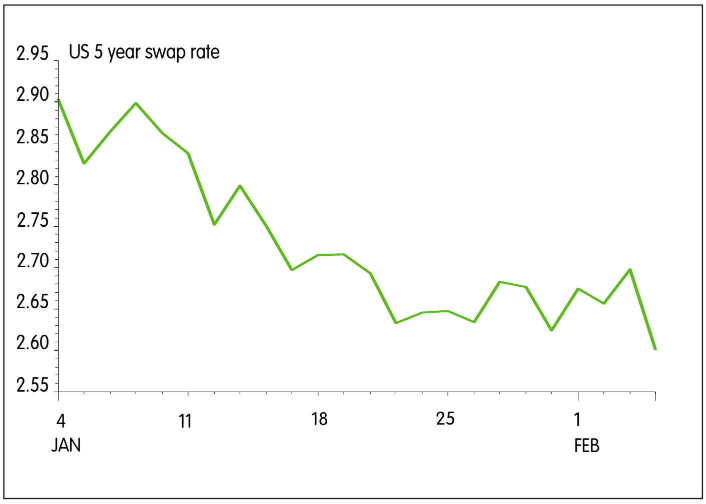


Chart 2: Euro 5yr swap falls to 2.50%

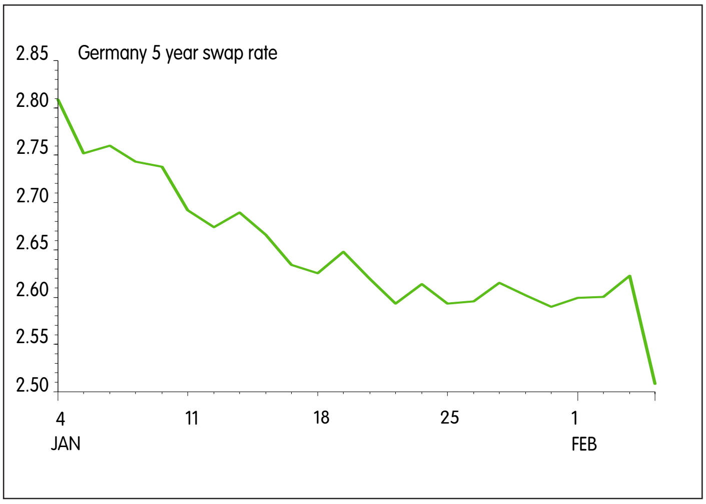


Chart 3: UK 5yr swap hits 3.05%

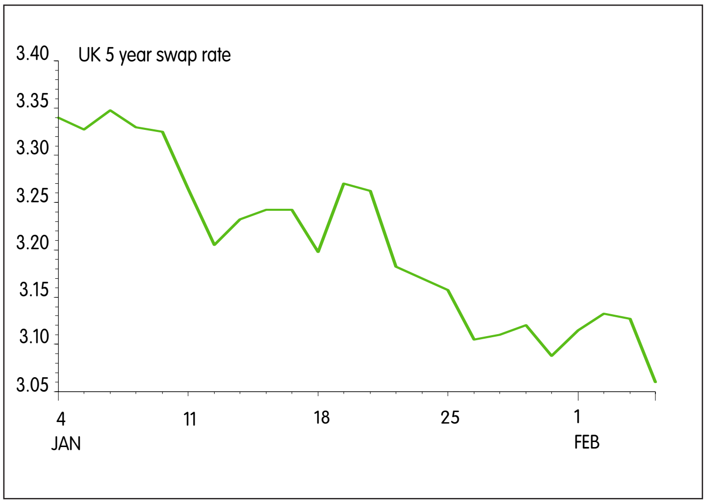


Chart 4: US curve flattens

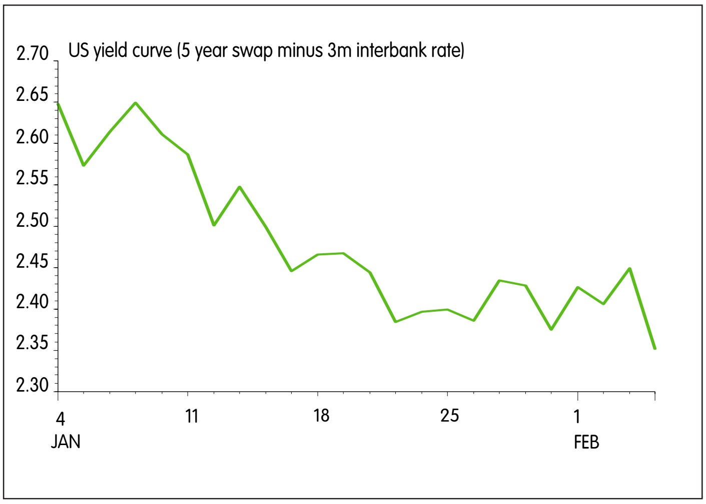


Chart 5: Eurozone curve spread narrows

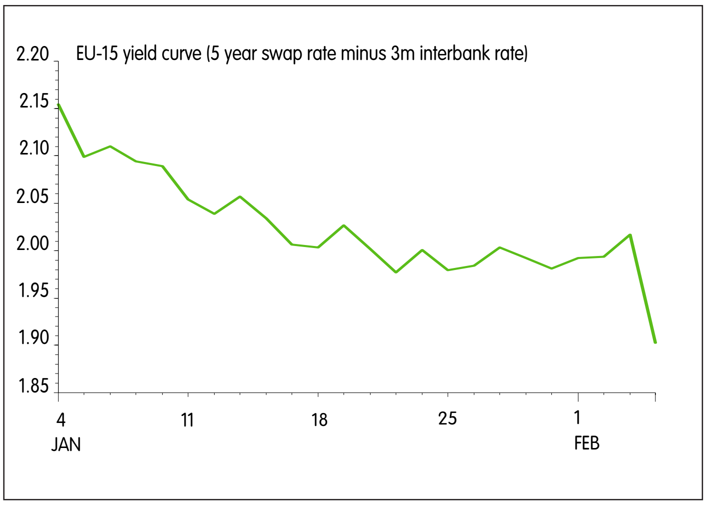
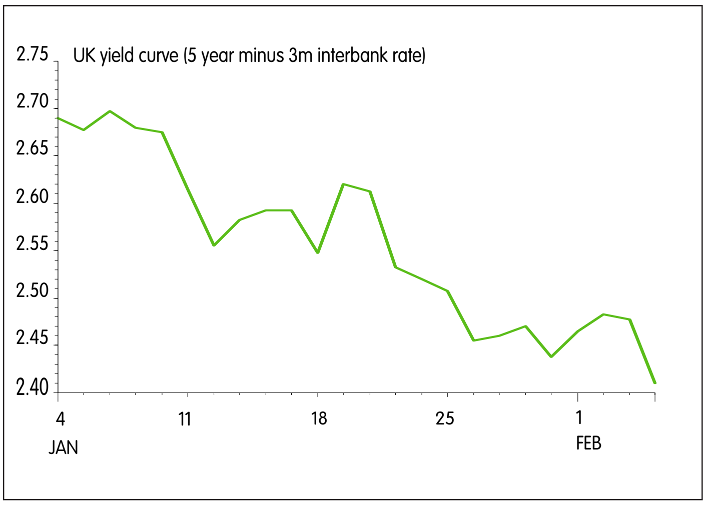


Chart 6: UK curve flatter



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Key commodity and equity markets - Graphical analysis of recent trends

Chart 1: Gold drops below $1,180

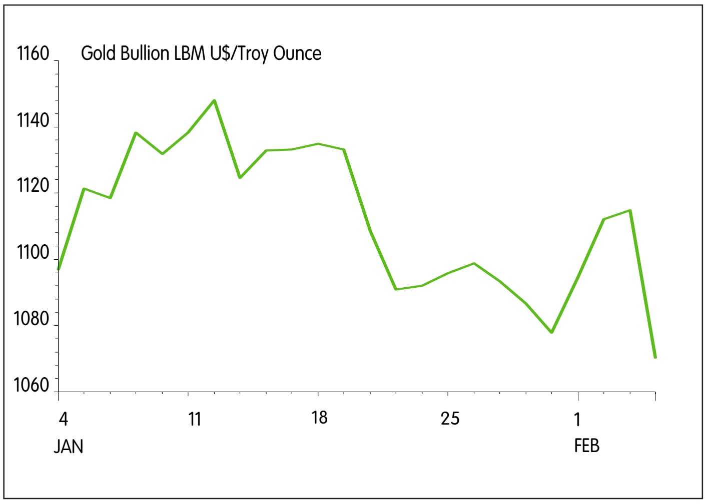


Chart 2: Brent crude erases mid-week gain

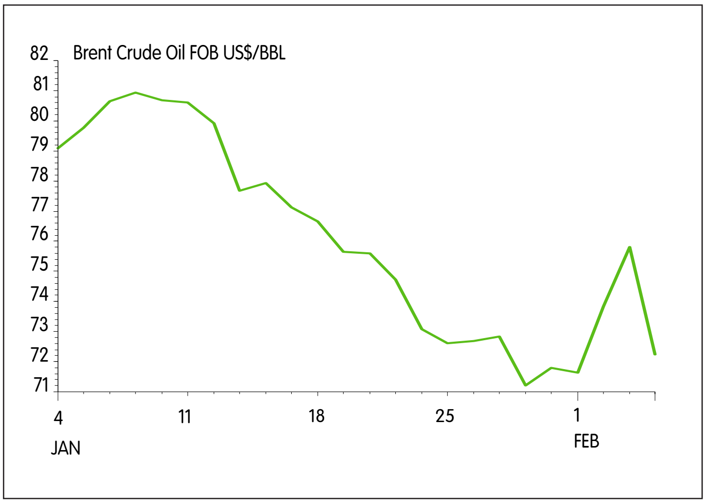


Chart 3: FTSE-100 loses ground

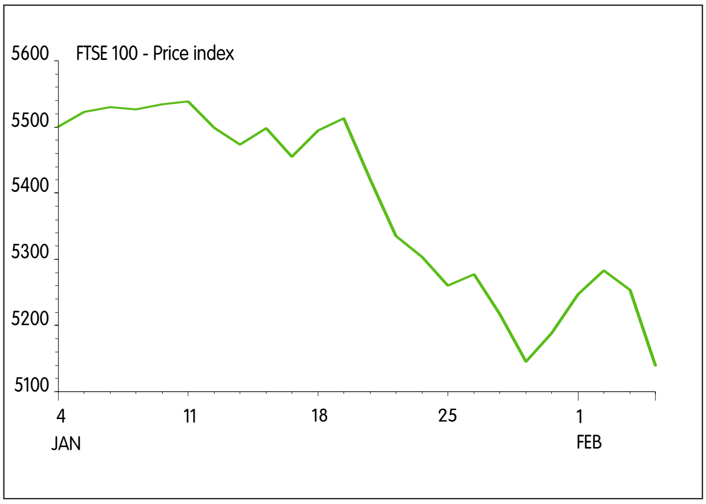


Chart 4: Dow Jones fell below 10,000

Chart 5: Nikkei finds support at 10,200

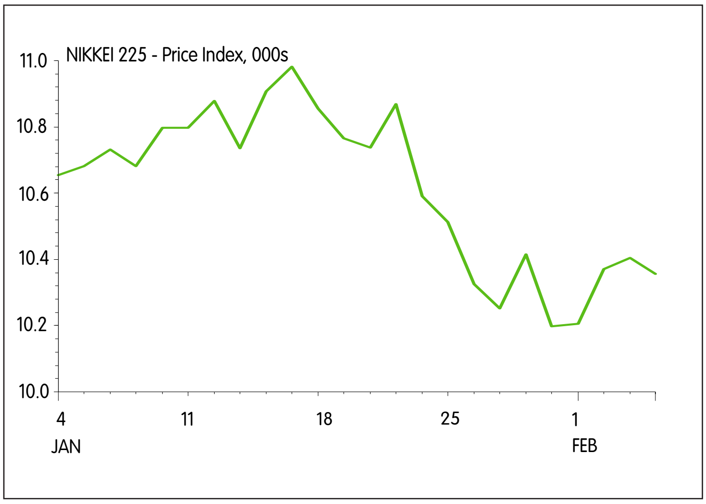
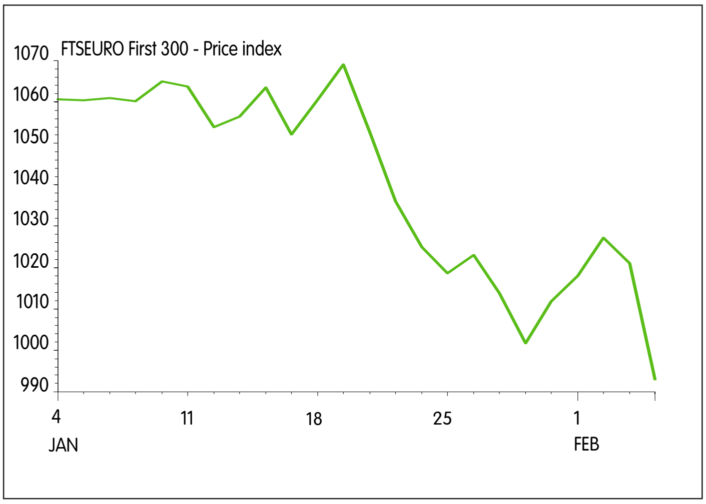


Chart 6: EuroFirst 300 through 1,000



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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