Financial Markets Review

13 November 2009

Sterling stumbles over BoE Inflation Report

In the G-10 currency space, the pound produced a mid table performance this week. It rose against low yielding currencies and lost ground to commodity currencies

The rally in global equity markets and widening interest rate spreads against the US provided a bearish environment for the USD

The USD's weakness against developed market currencies was mirrored across emerging market currencies

The Brazilian real bucked the strengthening emerging market currency theme - weakening against the USD as speculation grew that the government may raise the tax on foreign purchases of equities and bonds

Financial market review - foreign exchange

In the G-10 currency space the pound produced a mid table performance this week. The pound rose against the low yielding currencies (US dollar, euro, Swiss franc and Japanese yen) whilst it lost ground against the commodity currencies (Norwegian krone, Australian, New Zealand and Canadian dollars) and the Swedish krona.

It appears, the pound's woes emanated from the Bank of England's Quarterly Inflation Report, where it emerged that assuming implied market interest rates, inflation is forecast at 1.6% in two years time, well below the 2% target. This induced a sharp rally in short sterling interest rate futures contracts and left it under pressure. Additionally, Bank of England governor King reiterated that a weaker currency would help to rebalance the UK economy away from imports, towards exports. GBP/USD weakened by 1.4% following the Inflation Report.

UK economic data generally had a positive impact on sterling this week. The British Retail Consortium's retail sales report showed that October had been a strong month for retailers and the Royal Institute of Chartered Surveyor's report recorded a further increase in the balance of surveyors recording a rise in house prices. Comments by ratings agency Fitch prompted a bout of selling in sterling. The agency warned that amongst the top-rated nations, the UK's sovereign credit rating was most at risk of downgrade.

The USD has another disappointing week, falling against all G-10 currencies. The USD index recorded another, albeit marginal, new low for the year, before rallying 0.7% to end the week at 75.3. The rally in global equity markets (the S&P500 briefly traded at a new 2009 high) alongside widening interest rate spreads against the US, provided a bearish environment for the USD. US economic data were mixed - the National Federation of Industrial Business's small business optimum index rose slightly, whilst the University of Michigan consumer confidence indicator fell for the second consecutive month. The USD fell slightly in response to the US trade deficit, which deteriorated further in September. At $36.5bn, this is the worst since January.

€/$ fails to push beyond 1.50

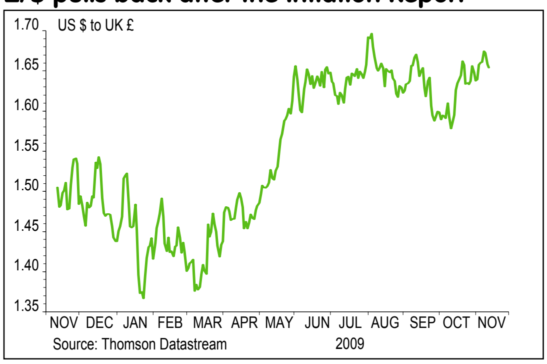
Financial market rates, ending Fri. 13 Nov 09

At 4.30pm, 13Nov 09		Change from 6 Nov 09
FTSE 100	**5296.38**	**+2.99%**
Exchange rates		
US$/UK£	**1.6684**	**+0.62%**
Euro €/UK£	**1.1206**	**+0.33%**
Euro €/US$	**1.4888**	**+0.28%**
Swaps - 5 year (mid)		**basis points**
UK pound	**3.32**	**-11.0**
US dollar	**2.59**	**-8.0**
Euro	**2.78**	**-5.0**
Bond yields - 10 year		
UK	**3.80**	**-8.0**
US	**3.44**	**-5.0**
Euro	**3.39**	**+4.0**

The USD's weakness was mirrored across emerging market currencies as well. One major exception to this is the Brazilian real, which fell 0.25% against the USD to close at 1.7240. The real slipped as speculation grew that the government may increase the tax (introduced earlier this year) on foreign purchases of stocks and bonds. The Chilean peso has been the leading emerging market currency this week, appreciating 3.9% against the USD. Expectations of strong economic growth and interest rate hikes has left the peso supported. The peso closes the week at a 15-month high against the US dollar.

Calls for China to allow its currency to appreciate are growing ever louder ahead of the US/China summit next week. Movement in USD/CNY has been severely restricted by the Chinese authorities (effectively pegging the currency pair) over the past year. Prior to that, the Chinese yuan appreciated 17% against the USD since 2005. In response, the Chinese central bank dropped a phrase promising to keep the currency stable in is latest quarterly monetary policy report – this triggered a fall in the FX forward rates.

£/$ pulls back after the Inflation Report



The longer end of the gilt curve drew good support and yields ended the week a fraction lower, supported by solid demand for UK and US 10 paper, and benign BoE inflation projections. UK 5y swaps dropped 11bps to 3.32%. 3-month libor ended the week unchanged at 0.61%.

2009/10 calendar of central bank meetings

European ECB (1.00%)
3 December, 14 February, 4 March, 8 April
US FOMC (0-0.25%)
16 December, 27 January, 16 March, 28 April
UK MPC (0.50%)
10 December, 7 January, 4 February, 4 March, 8 April

Rolling calendar of UK data releases and events

- CPI inflation (17/11)
- RPI inflation (17/11)
- BoE MPC minutes (18/11)
- Retail sales (19/11)
- M4 money supply (19/11)
- Public finances (19/11)
- Business investment (24/11)

Rolling calendar of US data releases and events

- Retail sales (16/11)
- Producer prices (17/11)
- TIC capital flows (17/11)
- Industrial production (17/11),
- CPI inflation (18/11)
- Housing starts (18/11)
- Q3 GDP (24/11)

Interest rate market review - bonds, cash and swaps

The BoE Quarterly Inflation Report (QIR) and the US Quarterly Refunding were the highlights of an otherwise fairly quiet and rangebound week in global government bonds. In the UK, a roll in the underlying 2y benchmark from March 2011 to December 2011 was responsible for a spike in the yield to 1.33%. The longer end of the gilt curve drew good support and yields ended the week a fraction lower, supported by solid demand for UK and US 10 paper, and benign BoE inflation projections. UK 5y swaps dropped 11bps to 3.32% and 3-month libor ended the week unchanged at 0.61%, resulting in a flatter curve. UK 5y CDS spreads rose to 60bps, the highest since August 19.

Bond yields and swaps oscillated in narrow ranges for most of the week with the exception of UK 2y yields, which spiked due to the changeover to a new benchmark, and the US 30y following lacklustre demand at the $16bn auction. For gilts and short sterling, the BoE QIR was the main focus after last week's QE increase to £25bn. However, the Bank kept its options open on further asset purchases and this helped to assuage some concerns for longer dated paper. The central projections for economic growth this year and next are little changed from those made in August, although the forecast for 2011 is almost one percentage point higher. Even after the upward revision to its medium-term growth forecasts, CPI inflation is expected to remain below 2% in two years time. We think there is ample scope for GDP growth (and presumably inflation) to undershoot the Bank's latest forecasts, potentially requiring further unconventional policy stimulus.

Data wise, UK BRC retail sales rose 3.8% y/y on a like-for-like basis in October, the biggest increase in since April. Labour market data showed the smallest rise in the claimant count total in October (12,900) since April 2008, but a decline in average earnings growth in September to 1.2% y/y, a five-month low, underlined the very subdued inflation backdrop. The ILO unemployment rate held was unchanged at 7.8% after a surprise downward revision to August from 7.9%. Next week brings the key October CPI and retail sales data and the November MPC minutes. A busy week for corporate sterling issuance raised roughly £750mn. Principal issers included were L-Bank Foederbank

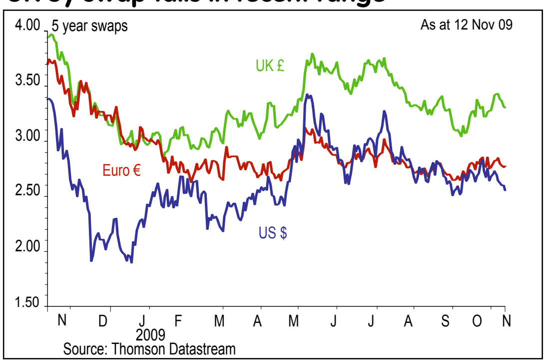
£/€ faces resistance around 1.12

(£300mn of 3y paper at 95bps over gilts), NRW Bank (£100mn of 3y paper at 95bps over). KFW (£100mn, 2013 at 58bps over gilts) and United Business Media (£250mn 7y paper at 325bps over). In terms of sovereign supply, the £3.75bn, 2019, 4.75% gilt was covered a solid 1.96 times and the £1bn, 1.25%, IL 2032 was covered 1.66 times.

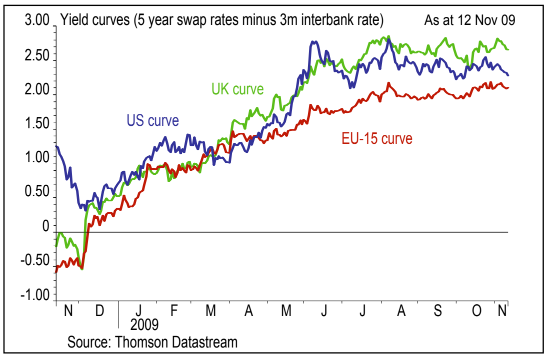
Strong buying at US 3y and 10y Treasury refunding auctions supported Treasury prices but average demand at the 30y auction from overseas bidders briefly triggered a rise in longer dated yields and a steeper curve. The 2y/10y spread touched 266bps, a 3 1/2 month high. 30y yields briefly rose to 4.47% but the move was partially reversed and the curve flattened on Friday, aided by disappointing US foreign trade and consumer confidence data. The latter showed a decline in one-year inflation expectations in November to 2.9% from 3.1%. US 10y swap spreads narrowed to 11bps, the lowest since May 22. Among the biggest corporate dollar issuers this week were Cisco ($2.5bn 2020; $500mn 2014 paper) and GE Capital ($1.5bn, 2014 paper). 5y swaps closed the week 8bps lower at 2.58%. US 3-month libor stayed flat at 0.27%.

Euro zone 10y bunds underperformed Treasuries and gilts, with yields rising 3bps to 3.39%, the upper end of the one-month range. Germany struggled to attract demand for new 10y paper, resulting in a bid/cover of 1.4 (3.37% yield). EU-16 Q3 GDP was a tad weaker than forecast at +0.4% q/q, but still marked the first expansion in six quarters. 5y swaps closed the week down 5bps at 2.78%.

UK 5y swap falls in recent range



UK yield curve steady around 210bps



Naeem Wahid, Economist
Altaz Dagha, Economist

Foreign exchange - graphical analysis of recent trends

Chart 1: £/$ turned lower after the inflation report

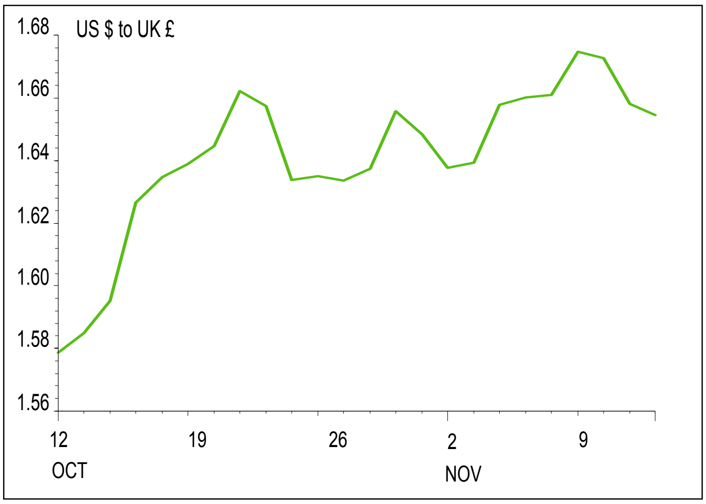


Chart 2: €/$ fails to push beyond 1.50

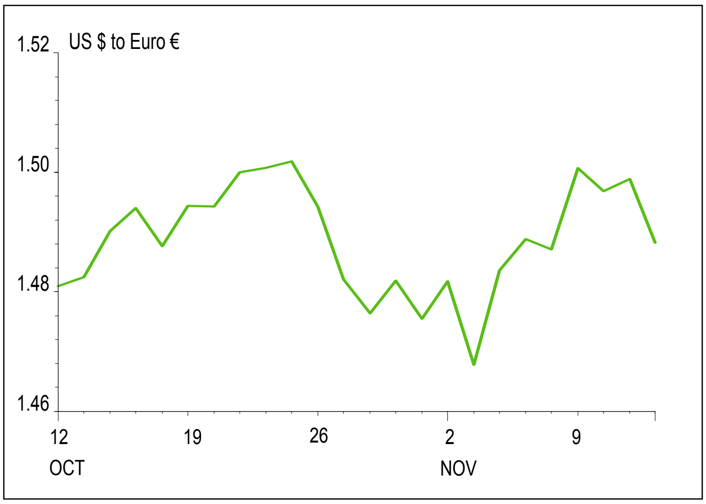


Chart 3: £/€ facing resistance around 1.12

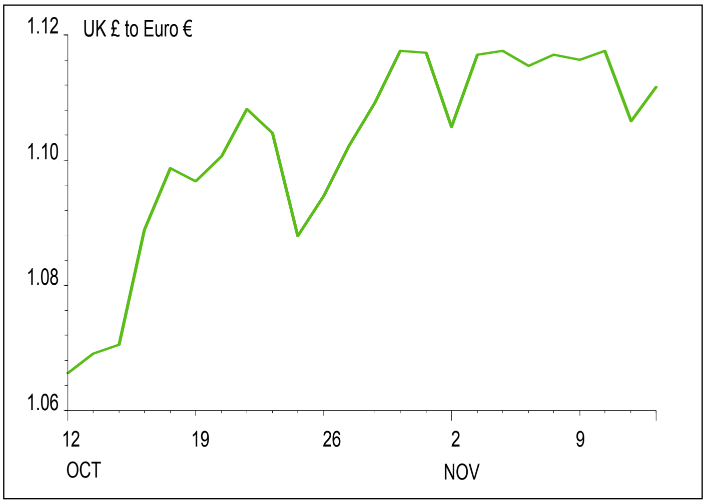


Chart 4: $/¥ forming a base below 90

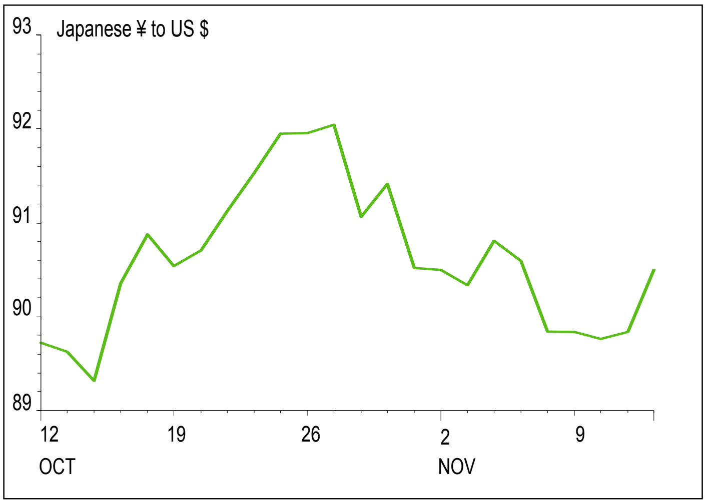


Chart 5: $/C$ pushing towards 1.04

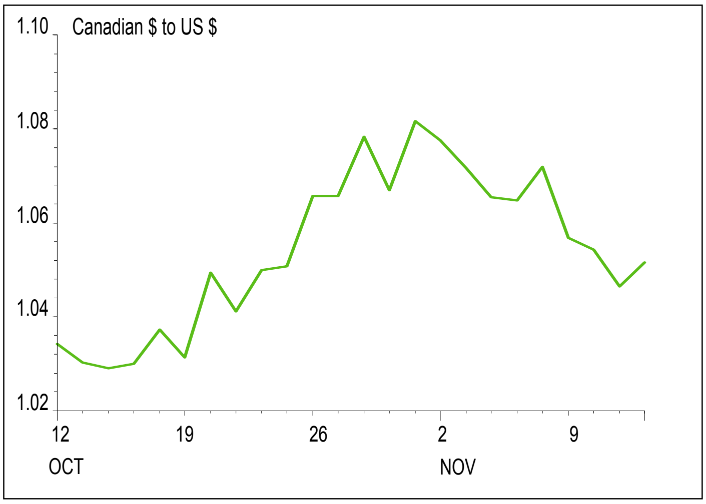
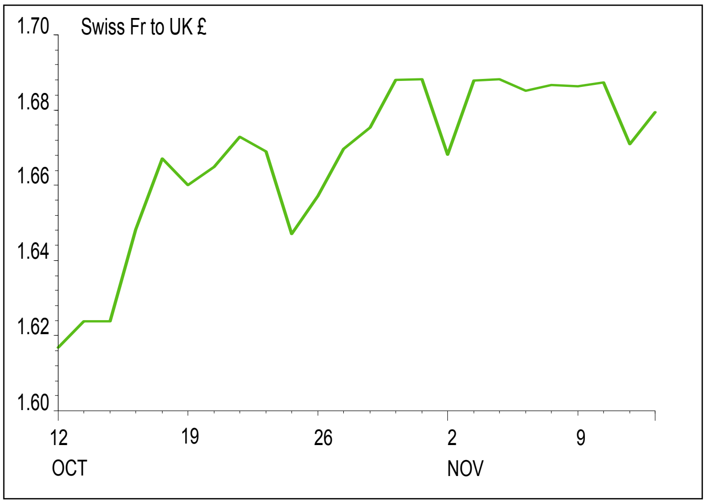


Chart 6: £/CHF becoming range-bound



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Fixed income - graphical analysis of recent trends

Chart 1: UK 2yr yield falls back on flat Bank rate outlook

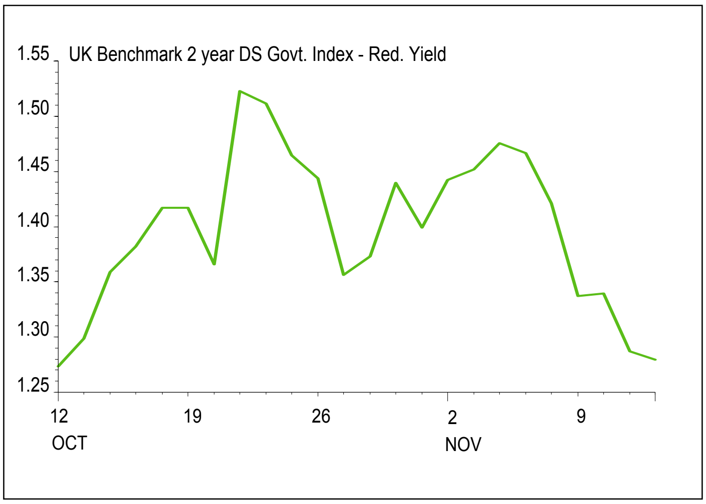


Chart 2: UK 10yr yield near recent high

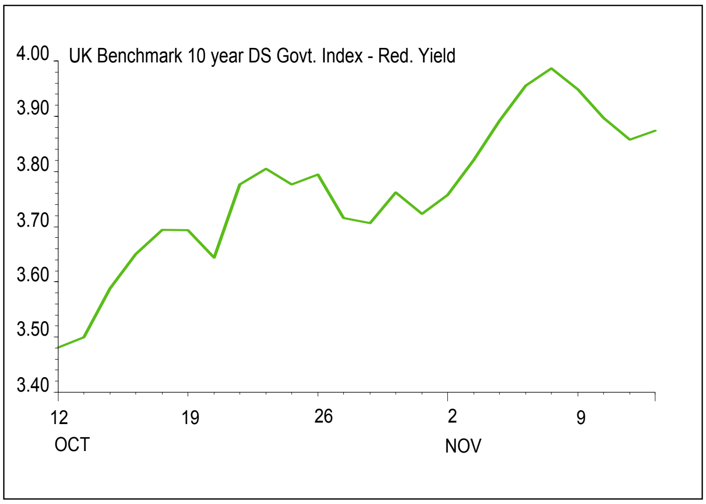


Chart 3: US 2yr yield falls back to 0.80%

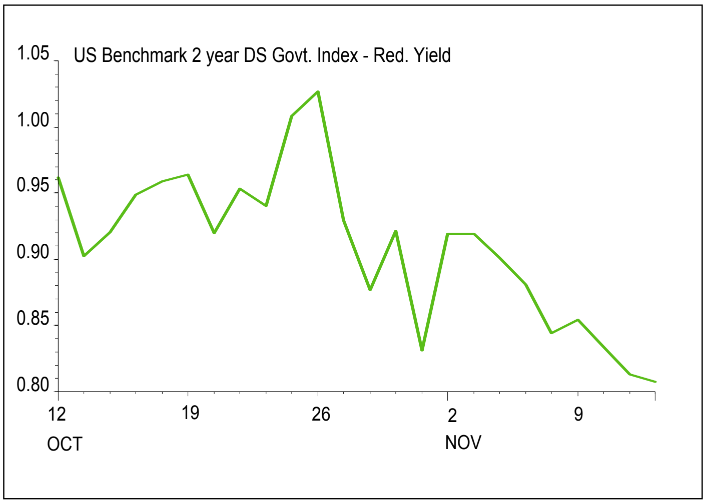


Chart 4: US 10yr yield falls on strong $25bn auction

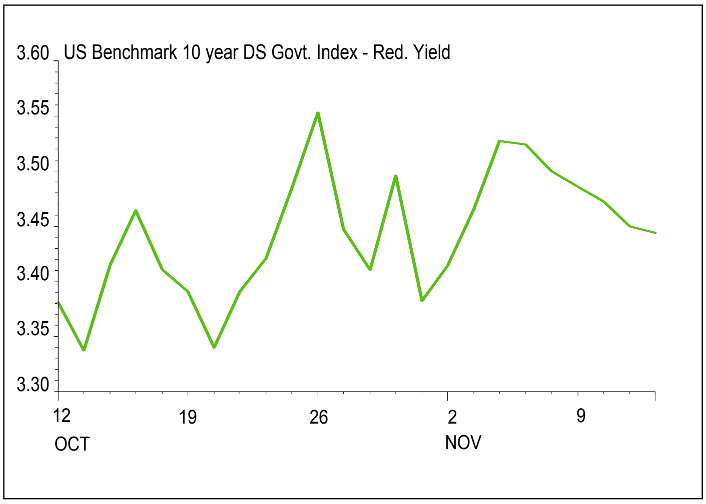


Chart 5: EU-16 2y yield falls back to 1.21%

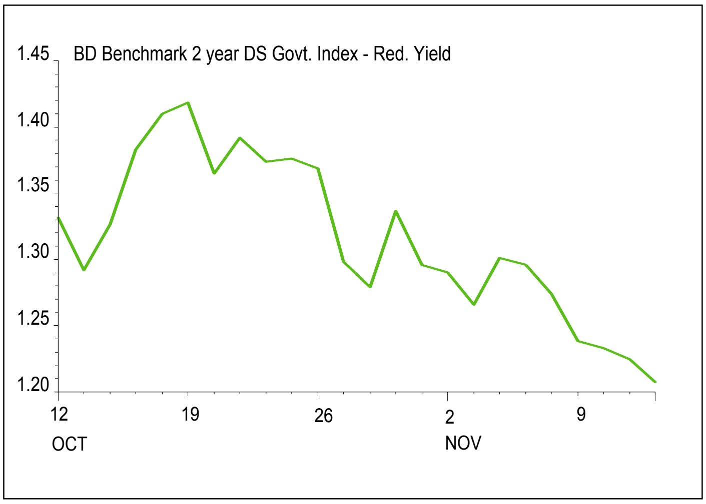
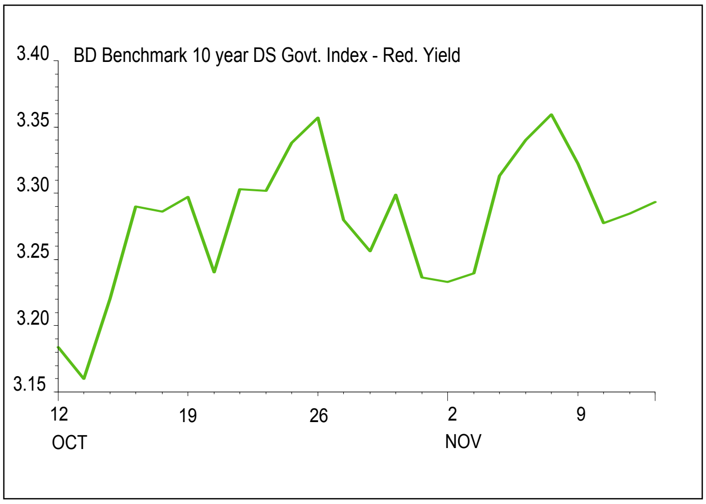


Chart 6: EU-16 10yr yield in recent range



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Interest rate markets - graphical analysis of recent trends

Chart 1: US 5yr swap drops back to 2.55%

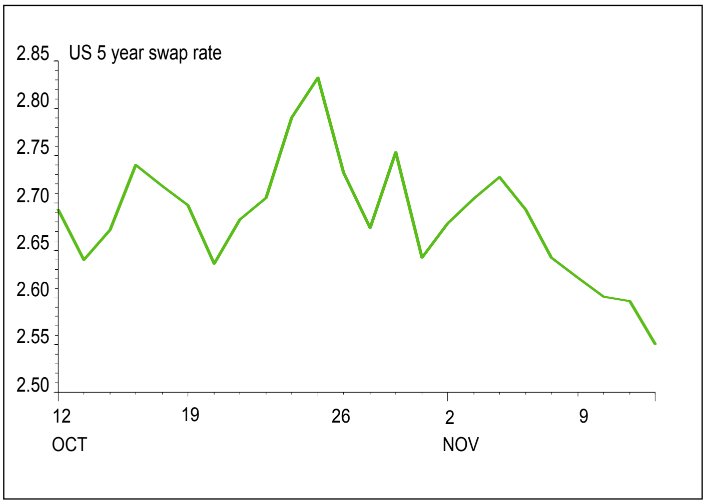


Chart 2: Euro 5yr swap steady above 2.75% support

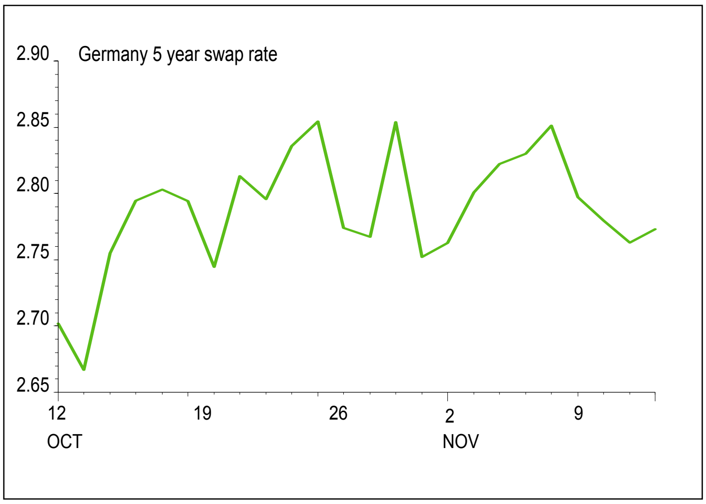


Chart 3: UK 5yr swap falls back to 3.30%

Chart 4: US curve flattens to 230bps

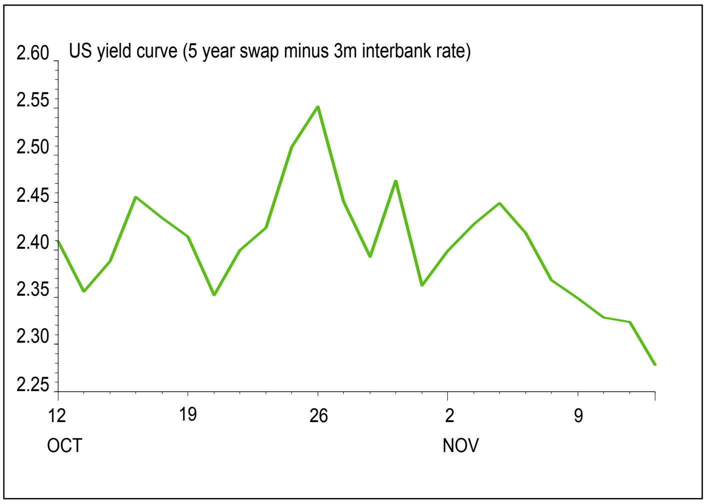


Chart 5: Eurozone spread steady around 210bps

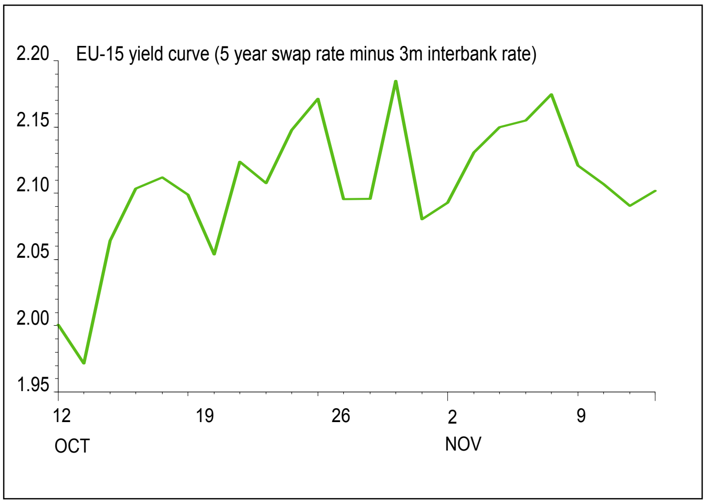
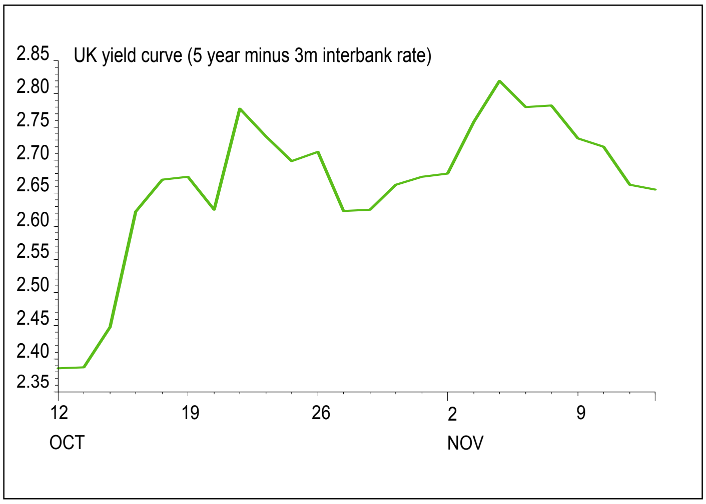


Chart 6: UK curve flattens as swap rate falls



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Key commodity and equity markets - Graphical analysis of recent trends

Chart 1: Gold hits a new record above $1,120

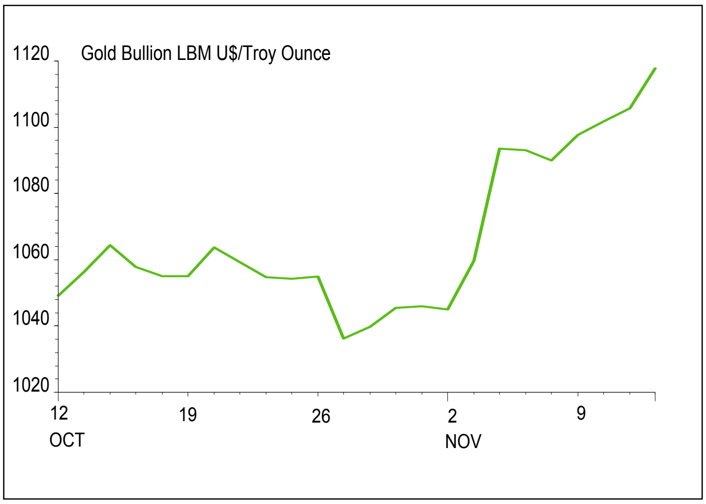


Chart 2: Brent crude oil drops below $77pb

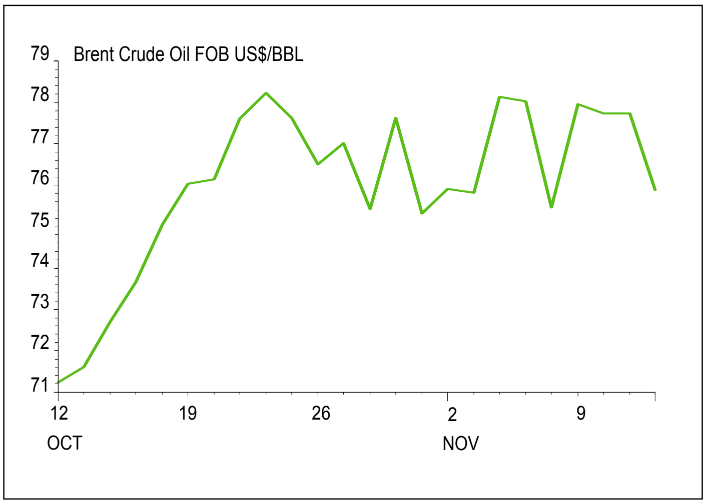


Chart 3: The FTSE-100 ends the week on a high

Chart 4: The Dow Jones surpasses 10,300

Chart 5: Nikkei underperforms on strong yen

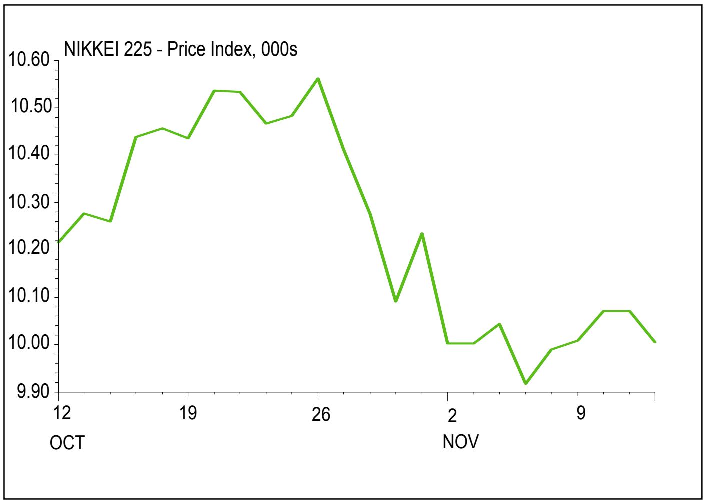
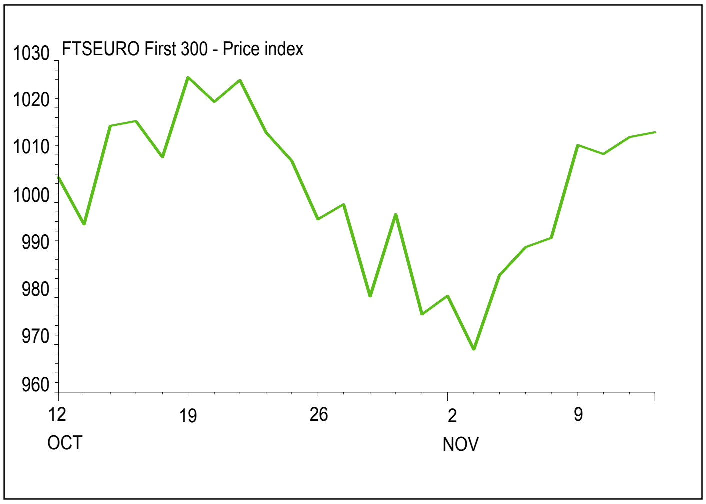


Chart 6: EuroFirst 300 tops 1,000



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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