Daily Market Strategy

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Market Strategy

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- **EUR relief bounce on EU Summit deal?**
- **Gilts extend post-Budget selling, poor US 5y auction weighs**

Market Outlook

Kenneth Broux

Opening levels (7.15am)

£/$: 1.4894	€/$: 1.3329	$/Y: 91.92
UK 5y sw: 2.91%	US 5y sw: 2.67%	EU 5y sw: 2.43%

Overnight

- UK Budget: Fitch retains stable outlook, S&P to review position after the general election
- weak US 5y auction: b/c 2.55 , indirects take 39.7%, directs get 10.8%, 4bp tail
- Wider US/G10 yield spreads boost dollar index

The overnight trading session saw the EUR sink below 1.33 vs the USD and lose further ground vs G10 counterparts, especially vs the AUD and CAD on positive news from Dubai (pro-risk) and hawkish comments by Bank of Canada governor Carney. Gilts continue to trade heavy after a weak US 5y auction overnight and a nervousness on the gilt issuance outlook based on rosy Budget assumptions for the economy, and leads 10y gilt yields to extend their post-Budget bounce over 4% and a steepening in 2y/10y cash and swaps curves. Stronger UK Feb retail sales data could cause selling in fixed income product to intensify, putting yields on course for a test of trendline resistance at 4.08%, with 4.15% looming beyond. EU member states will gather today and tomorrow in what could be the proverbial last chance saloon to salvage an agreement on emergency assistance for Greece, with the direct involvement of the IMF.

Ahead today

- UK: retail sales for Feb are expected to show a 0.6% m/m gain but optimism may be tempered by a disappointing CBI distributive trades survey earlier in the week/ Reported sales fell back to 13 vs 23, marking a second decline in three months.
- EU: all eyes on the EU summit. The stakes are raised from last month when the EU pledged that 'it stood' behind Greece. Markets want to know what any assistance looks like and whether the IMF will be involved in efforts to restore investor confidence. M3 money supply data for Feb is forecast to have stayed unchanged at -0.1% y/y/
- US: Fed chairman Bernanke testifies on exist strategy this afternoon. This comes just a week before the expiry of the Fed's agency and MBS purchase programme. Talk of a discount rate hike surfaced this time last week. The Treasury sells $32bn, 7y notes (last 7y auction stats: b/c 2.98, indirects 40.3%, directs 17.2%). The consensus forecast for weekly claims is 450k.

FX: the EUR should stay in the spotlight today as EU Head of State get together. Germany has expressed that it does not wish to see Greece discussed, so it will be interesting to see if any statement ion Greece is released before the Summit gets underway. EUR/USD hit a 1.3278 low overnight, but buying on dips lifted the cross back over 1.33. Only a clear package to help Greece will put short term worries to rest and could trigger good follow though buying in EUR crosses, with short covering adding momentum. Our medium-term view is for further EUR weakness, we buy a bounce in EUR/USD at 1.34 for a rally up to 1.35. For GBP crosses, a disappointing retail sales number at 9.30 will keep bearish pressure intact post Budget. GBP/USD did well to bounce back over 1.49 overnight, but lack of conviction should bring out sellers if sales come in short of 0.6% consensus. We target a test of 1.4784, the March 1 low, with 1.45 a realistic target ahead of the General Election. Hawkish comments by Bank of Canada governor Carney overnight (possibility of rate rise in June) is boosted CAD crosses overnight, squeezing GBP/CAD back below 1.5250. Our EUR/CAD target is 1.35.

Rates: UK 5y swaps edge up to 2.92% in listless early trading, but the action is found in gilts where selling lifts 10y clear of 4%. Dubai, the US auction and nervousness over gilt issuance and previously overnight conditions are causes of the selling that should see yields stretch to 4.08% unless retail sales disappoint at 9.30. The bearish steepening pushed 2y/10y swaps out to 227bp, with cash spread widening to 278bp. A sloppy US 7y auction could see losses accelerate.

	Close	Daily Change %
FX		
EUR/GBP	0.8957	-0.17%
GBP/USD	1.4868	-1.20%
EUR/USD	1.3315	-1.36%
USD/JPY	92.300	2.10%
AUD/USD	0.9074	-1.24%
Bonds %		**bp**
US 10Yr	3.852	16.7
EUR 10Yr	3.079	2.3
UK10 Yr	3.979	6.2
UK 5yr Swap	2.913	3.0
Equities		**%**
S&P500	1167.72	-0.55%
FTSE100	5677.88	0.00%
Eurostoxx50	2903.94	0.00%
Shanghai Composite	3019.18	-1.23%
Commodities		**%**
Crude Oil $/bl	80.61	-1.59%
Gold $/oz	1086.7	-1.67%
Copper	334.6	-0.99%
Baltic Dry	3243	-1.13%
Other		
VIX	17.55	7.34%
iTraxx XOVER	440.32	-4.0

Daily Change %
-0.06%
-0.34%
-0.44%
0.29%
0.05%
bp
2.7
-1.4
-0.5
-2.8
%
0.72%
0.00%
0.00%
0.12%
%
0.81%
0.26%
-0.04%
-1.71%
-3.08%
-16.0

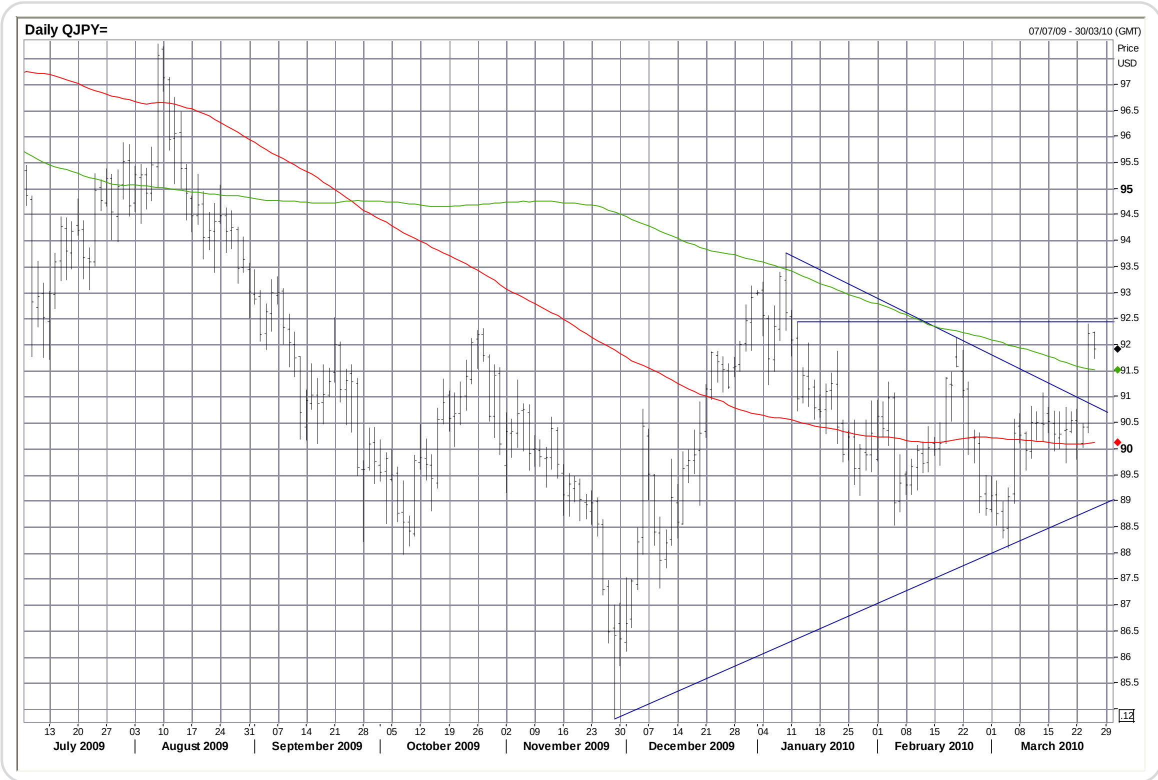
Today's Data	Time	Consensus	Previous
UK Retail Sales, Feb	09:30	0.6%	-1.2%
German GfK Consumer Confidence, Apr	07:00	3.2A	3.2
EU-16 M3 money supply, Feb, y/y	09:00	-0.1%	-0.1%
US Weekly Claims, Mar 20	12:30	450k	457k

Events

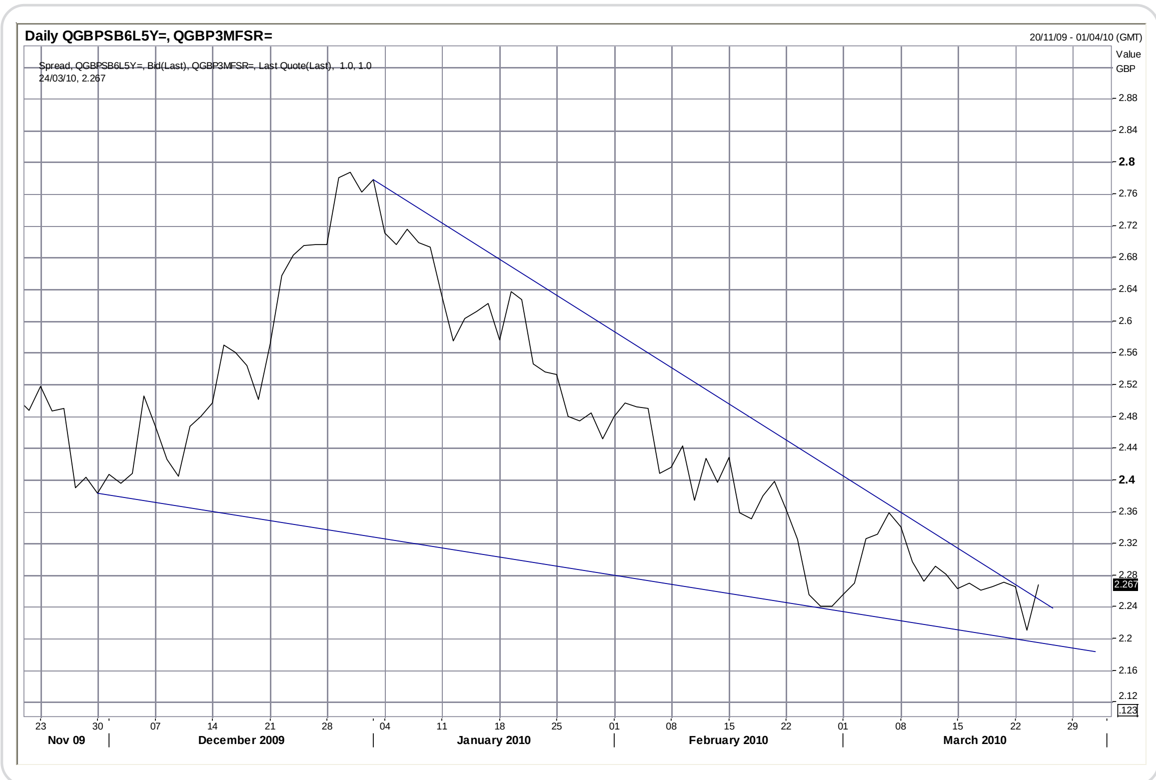
ECB speakers: president Trichet (08:00), Gonzalez Paramo (18:30)
Fed chairman Bernanke testifies on Exit Strategy (14:00)
Fed speakers: Pianalto (13:15), Kohn (tbc)
US sells $32bn 7y notes

*All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg , DataStream & CQG

USD/JPY: running into resistance at 92.40



UK 3mth libor/5y swaps: trend break at 227bp?



GBP/AUD: still targeting 1.50

UK retail sales: underpinned by non-food

Financial Markets

Gilts

The Debt Management Office (DMO) announced gross gilt issuance will fall to £187.3bn in 2010/11, compared with the final figure of £227.6bn in 2009/10. This marks the first reduction in issuance since 2007. Planned sales will be comprised of £187.3bn of gilts and net redemptions of Treasury bills of £1.9bn, with the biggest absolute burden of sales falling on short-term conventional paper. The biggest percentage change vs total gilt sales is planned to be inflation-linked bonds.

The bulk, £148.1bn (79% of planned issuance), will be sold through pre-announced outright auctions as normal but the DMO have decided to continue with last year's initiative of using syndication and mini-tenders as a distribution method in the next fiscal year. Ten syndicated offerings are planned to sell a total of £29.2bn of gilts (£0.8bn lower vs 2009). Mini-tenders will account for a total of £10bn of sales (£1bn more than 2009). These supplementary methods will focus on long-dated conventional gilts (£18.6bn) and index-linked paper (£20.6bn) which have on occasion struggled to attract sufficient demand.

Closer analysis of the breakdown by maturity shows that the largest relative decline in gilt sales is earmarked for medium-term maturities (7-15y). Projected issuance is projected to drop to £45bn, or 24% of all sales. This marks a reduction from 31% in 2009. This is no surprise and must be seen in the context of the BoE's asset purchase programme. Until QE was paused at £200bn in February, the Bank was the biggest buyer of medium-term paper, raising its holdings of 2018, 2020 and 2022 paper to over 55% since the start of the APF just over a year ago. Now that the Bank has stopped buying, the DMO is reducing the share of 7-15y paper, focussing on more liquid areas of the yield curve. A drop is also planned in sales of short duration gilts (less than 7y) to £59bn. This marks a relative fall vs total sales to 31.5% from 33%. Sales of long term gilts (maturity over 15y) are scaled back to £45.3bn vs £51.6bn, but bumps up its relative share to over 24% from 22.7%. The biggest net change is set to take place in index-linked gilts where sales will rise to £38bn from £29.3bn last year. This marks an increase to just over 20% vs 12.9% in 2009. The sharp rise in inflation-linked sales is obviously based on optimism that RPI inflation will stay low through the 2010/11 period.

While the planned issuance for the fiscal year 2010/11 is lower than last year, the market had held out hope of an even lower number of £170bn given the recent better than expected PSNB figures. As a result, the gilt curve resumed its steepening tendency on the announcement with both the 2y/10y and 10y/30y yield spreads reversing their recent flattening skew. 10yr and 30y yields rebounded from oversold levels.

The reduction in the financing requirement for 2010/11 reflects a reduced Central Government Net Cash Requirement (CGNR) of £22.4bn vs the December PBR (to £200.9bn) and £7.6bn (to £166.4bn) for 2009/10 and 2010/11 respectively. For the fiscal year 2010/11, £4.0bn has been added to the gross financing requirement to finance the foreign exchange reserves while the contribution to financing from National Savings & Investments is assumed to be zero.

Chart a: Planned share of index-linked gilts to top 20%

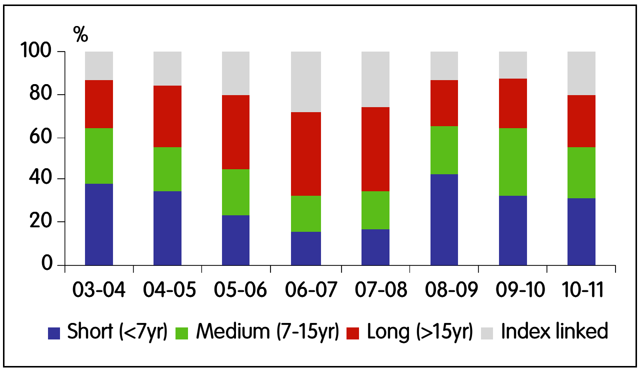


Chart b: 10y yields have rebounded to 4% over the past year

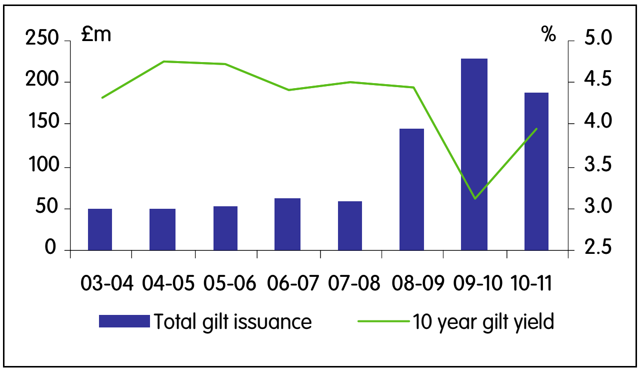
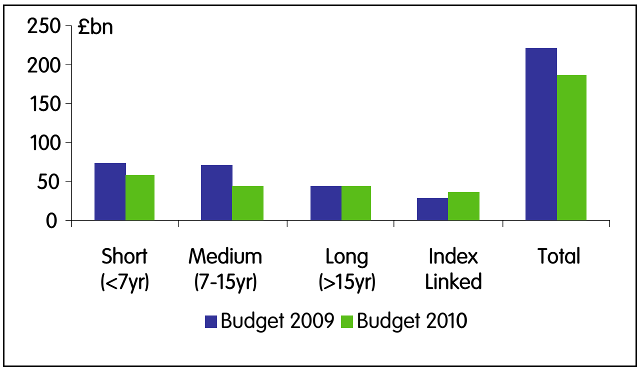


Chart c: Total issuance to fall by £40.3bn to £187.3bn in 2010/11



Source: DMO

Planned gilt sales in 2010/11 include:

- £59.0bn in short-term conventional gilts
- £45.0bn in medium-dated conventional gilts
- £45.3bn in long-term conventional gilts; of which £26.7bn via auction, £12.8bn via syndication and £5.8bn via mini-tender
- £38.0bn in index-linked; of which £17.4bn via auctions, £16.4bn via syndication and £4.2bn via mini-tender

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USD/JPY	92.30	2.10%
AUD/USD	0.9074	-1.24%
EUR/GBP	0.8957	-0.17%
GBP/EUR	1.1166	0.18%
GBP/USD	1.4868	-1.20%
GBP/JPY	137.23	0.88%
GBP/CHF	1.5950	0.25%
GBP/AUD	1.6383	0.03%
GBP/CAD	1.5266	-0.14%
GBP/NZD	2.1179	-0.43%
GBP/NOK	8.9823	0.45%
GBP/ZAR	10.9924	-0.27%
GBP/CNY	10.1489	-1.20%

Bonds %		bp
US 10Yr	3.852	16.7
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DJ Agriculture Index	58.56	0.00%

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Shanghai Composite*	3019.18	-1.23%

*latest price

Commodities		%
Crude Oil $/bl	80.61	-1.59%
Gold $/oz	1086.7	-1.67%
Copper c/lb	334.6	-0.99%
Silver $/oz	16.58	-2.70%
Baltic Dry	3243	-1.13%

Swaps %		bp
US 5yr	2.701	9.9
EUR 5yr	2.429	3.0
UK 5yr	2.913	3.0

Official Rates %	
UK	0.50
US	0.25
EU	1.00
Japan	0.10