



Financial Markets Review

6 November 2009

BoE expands QE to £200bn, sterling strengthens

In the G-10 currency space, the pound ended the week in the middle of the league - the pound did manage to rally against the US dollar, with GBP/USD closing the week 0.7% higher at \$1.6582.

The Bank of England increased its quantitative easing programme by only £25bn, which provided a boost for sterling.

The US dollar fell after the labour market report. The US unemployment rate rose to its highest since 1983, hitting 10.2% in October.

The rise in global PMIs supported equity markets and emerging market currencies. The South African rand also benefited from the rise in the gold price to a record \$1,100 per ounce.

The European Central Bank left the refinancing rate unchanged at 1%, in line with market expectations. ECB President Trichet noted that "not all our liquidity measures will be needed to the same extent as in the past".

Financial market review - foreign exchange

In the G-10 currency space, the pound ended the week in the middle of the league. The pound did manage to rally against the US dollar, with GBP/USD closing the week 0.7% higher at \$1.6582. Sterling fell slightly against the euro, ending at €1.1169. UK economic data have been strong this week. Industrial and manufacturing production data as well as manufacturing and services PMI surprised higher, giving GBP/USD a boost throughout the week.

The Bank of England increased its quantitative easing programme by £25bn, bringing it to a total of £200bn. The latest gilt purchases will occur over the coming three months. The slowdown in the pace of asset purchases, provided support for sterling in currency markets. Implied volatility, in GBP/USD and EUR/GBP, fell sharply after the Bank's announcement. 1-month volatility had reached a 4-month high prior to the announcement.

The US dollar has had a disappointing week, giving up most of last week's gains – the USD index is less than 1% away from the 2009 low. The US manufacturing and service sector ISMs remained above 50, suggesting further expansion during October. This was positive for equities and provided some downward pressure on the USD. The Federal Reserve kept the target rate unchanged (0-0.25%) and there was little modification to the accompanying statement – as such, its impact on the USD was negligible. The US labour market report indicated that the unemployment rate rose to 10.2% in October, the highest since 1983. This weighed on the USD, pushing the USD index approximately 0.4% lower.

The European Central Bank left the refinancing rate unchanged at 1%, in line with market expectations. ECB President Trichet noted that "not all our liquidity measures will be needed to the same extent as in the past". This mild talk of exit strategies gave a short-term boost to the euro.

The New Zealand dollar has also been an underperformer in the G-10 space this week. Reserve Bank of New Zealand Governor Bollard warned that financial markets need

Financial market rates, ending Fri. 6 Nov 2009

At 4.30pm 6 Nov 09		Change from 30 Oct 09
FTSE 100	5142.72	+2.35%
Exchange rates		
US\$/UK£	1.6582	+0.70%
Euro €/UK£	1.1169	-0.03%
Euro €/US\$	1.4847	+0.72%
Swaps - 5 year (mid)		
UK pound	3.43	+18.0
US dollar	2.66	-2.0
Euro	2.83	+7.0
Bond yields - 10 year		
UK	3.88	+26.0
US	3.49	+8.0
Euro	3.35	+12.0

to appreciate the difference between New Zealand and Australia. Whilst Australia has benefited from strong terms of trade, vast mineral deposits, the Chinese market and rapid population growth, New Zealand, on the other hand, has had a recession and the pick-up in activity is slower and more vulnerable. This triggered a sell-off in the NZD – something the governor would be supportive of (given the 25% appreciation in NZD/USD this year).

The USD has largely fallen against emerging market currencies. Strong economic data (global PMIs have risen further into expansionary territory), leading to a rise in growth expectations, has boosted equity markets. In this context, it is not surprising that the South African rand and the Brazilian real are amongst the strongest emerging market currencies this week, rising 3.6% and 2.5% respectively, against the USD. The South African rand also benefited from the rise in the gold price, which ended the week having traded at a record \$1,100 per ounce. Finally, news that the South African central bank will refrain from intervening to stop the currency appreciating provided a boost for the rand.

€/£ maintains upward trend



£/\$ still pushing towards \$1.67



The underperformance of gilts vs Treasuries and bunds was accentuated on Wednesday when the BoE decided to increase QE by 'only' £25bn to £200bn. UK 5y swaps touched 3.49%, the highest since August 28th.

Interest rate market review - bonds, cash and swaps

Government bonds were under pressure for most of the week but the report on Friday of a jump in the US unemployment rate to 10.2%, a 26-year high, brought some relief even as equities pushed higher. The underperformance of gilts vs Treasuries and bunds was accentuated on Wednesday when the BoE decided to increase QE by 'only' £25bn to £200bn. UK 5y swaps touched 3.49%, the highest since August 28th. UK 3-month libor rose 2bps to 0.61%, causing a widening in the Bank rate spread to 11bps.

£/€ trying to climb higher



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

The busiest week of Q4 delivered a couple of minor surprises but did not alter underlying trends in government bonds. Longer dated yields have settled at the upper end of trading ranges since mid-October and this week saw those trends further embedded. A breakout of 3.50% for UK 5y swaps is looking increasingly likely as markets shrugged off the worst US unemployment rate since 1983 (10.2%). The quarterly US Treasury refunding is scheduled for next week and could keep longer-term yield under upward pressure. For UK 10y yields, a move closer to 4% looks inevitable after touching 3.90% this week.

US Treasuries were on the back foot for most of the week, with yields rising on stronger October ISM manufacturing data and a record Treasury Refunding announcement for next week (\$81bn). The unchanged FOMC statement and the weaker than expected US October employment report provided temporary solace but could not stop 10y yields from reaching 3.56%. By contrast, 2y yields fell back to the lower end of the trading range around 0.84%, causing the yield curve to steepen through 265bps. 5y swaps fell 2bps to 2.66%. US 3-month libor fell one bps to 0.27%. Fed fund futures rallied on the shock rise in the unemployment rate above 10% and now implies that the Fed will keep interest rates on hold longer in 2010. Major dollar issuers this week were Freddie Mac (4.5bn, 2011 paper at 26bps over Treasuries), Abbey National (1.5bn 2014 paper at 150bps over), Nordea (total 2bn, of which 1.5bn 2014 at 140bps over and 500mn 2012 at 120bps over). IBM launched 1.25bn, 2013 paper at 70bps over Treasuries.

Rolling calendar of UK data releases and events

- Trade balance (10/11)
- Official house prices (10/11)
- Labour market stats (11/11)
- BoE Q4 QIR (11/11)
- CPI inflation (17/11)
- RPI inflation (17/11)
- BoE MPC minutes (18/11)

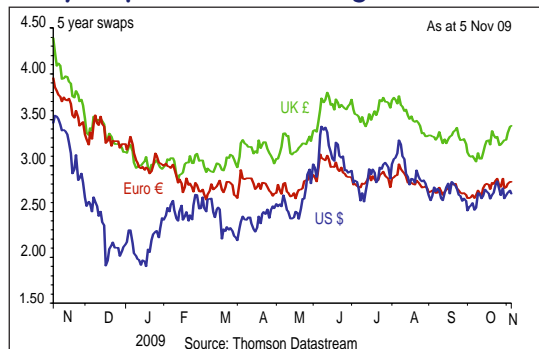
Stronger than expected outcomes for the UK October PMIs highlighted the prospects for recovery in Q4 and were credited for the weakness in gilts. Along with a much stronger US manufacturing ISM survey, this sparked a steepening of global yield curves over the early part of the week. The UK 2y/10y swaps spread widened to 200bps. The two UK PMI surveys, progressing simultaneously in expansion territory in October for the first time since July, added to existing confusion about the underlying state of the economy and raised hopes for an upward revision to Q3 GDP from -0.4% q/q later this month. NIESR data showing growth falling 0.4% in the quarter to October did little to dampen this belief. Stronger than expected UK September manufacturing output data as well as stronger September car sales added to the positive backdrop for yields. 5y swaps broke the September 23 high of 3.44% and scaled a high of 3.49% as paying interest stepped up. Corporate sterling issues this week were noted from Virgin Media (350mn 2019 paper at 142bps over gilts) and William Hill (300mn of 2016 paper at 7.25%).

The ECB's comment on Thursday that liquidity operations may be placed under review next month put pressure on bunds and caused 2y yields to jump over 1.35%. The bigger rise in 10y yields, partly attributed to heavy longer-term sovereign supply, caused a steepening of the yield curve through 200bps. 3-month Eonia was steady around 0.45% after ECB president Trichet said that the Bank has no immediate intention to re-align Eonia with the 1.0% refi rate. Corporate issuers in euros this week included Irish Nationwide (2.269bn) and Commonwealth Bank of Australia (1.5bn, 2016 at 108bps over mid-swaps). EU 5y swaps closed the week 7bps higher at 2.83%.

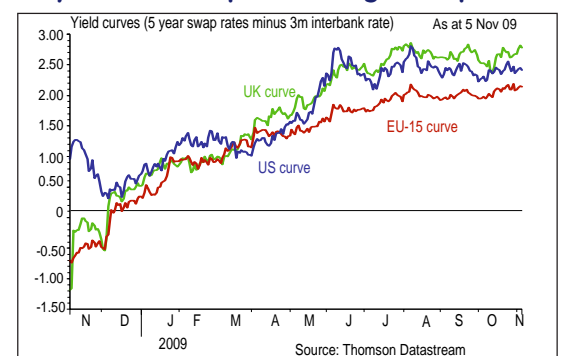
Rolling calendar of US data releases and events

- Trade balance (13/11)
- 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)

UK 5y swap reached a 3.49% high



UK yield curve steepened through 280bps



Naeem Wahid, Economist
Altaz Dagha, Economist

Foreign exchange - graphical analysis of recent trends

Chart 1: £/\$ pushing towards 1.67

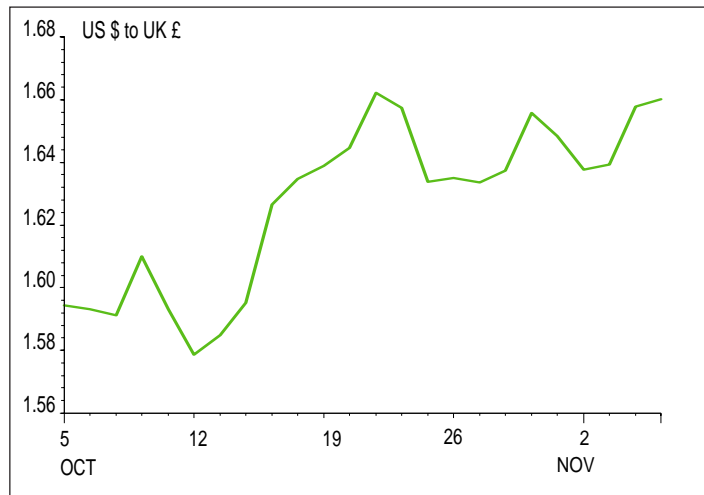


Chart 2: €/€ beginning to stabilise around 1.4850

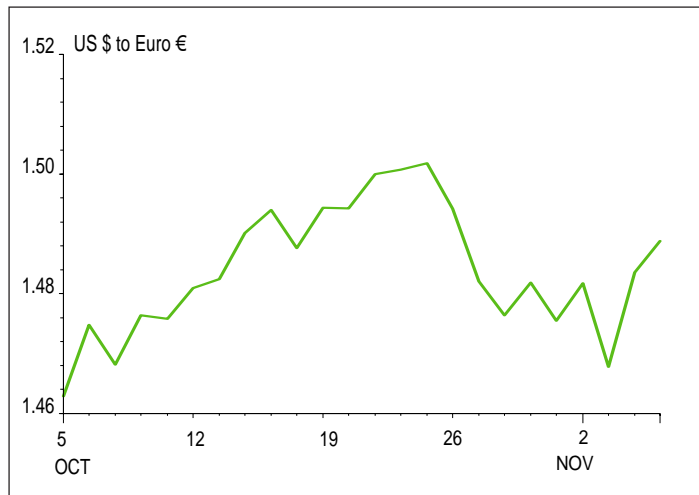


Chart 3: £/€ gradually climbing, resistance at 1.12



Chart 4: \$/¥ back below ¥92

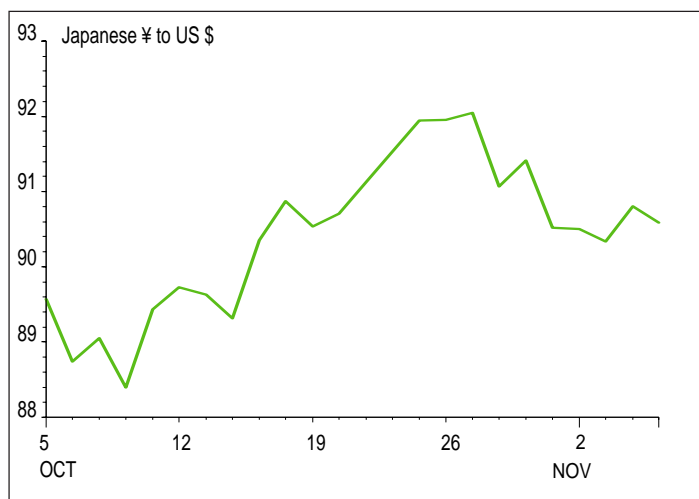


Chart 5: \$/C\$ falling back below 1.08

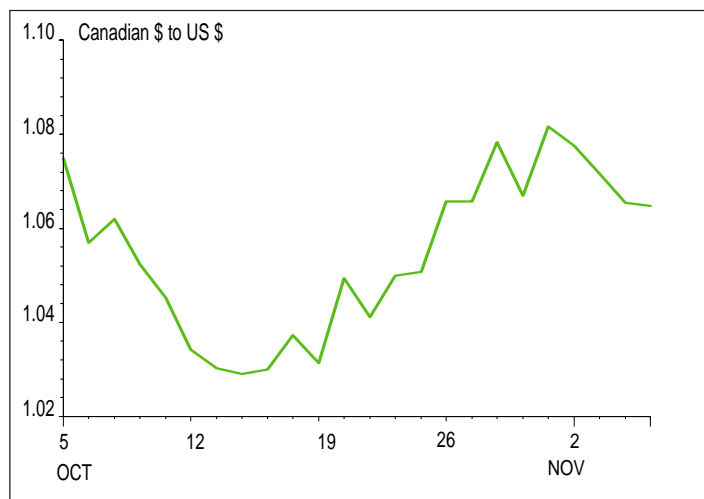
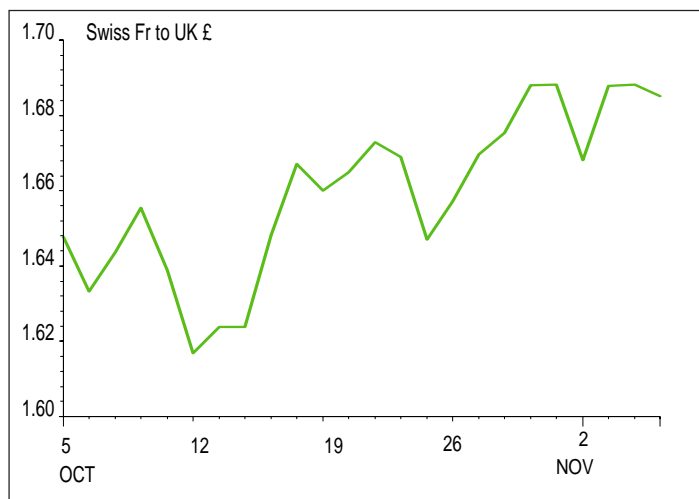


Chart 6: £/CHF back towards 1.70



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Fixed income - graphical analysis of recent trends

Chart 1: UK 2yr yield jumps to 1.45% (Dec-11 benchmark)

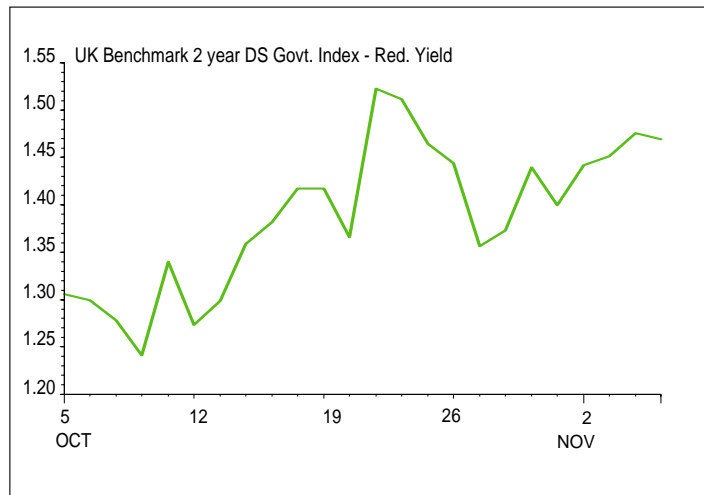


Chart 2: UK 10yr yield approaches 4%



Chart 3: US 2yr yield falls back below 0.90%

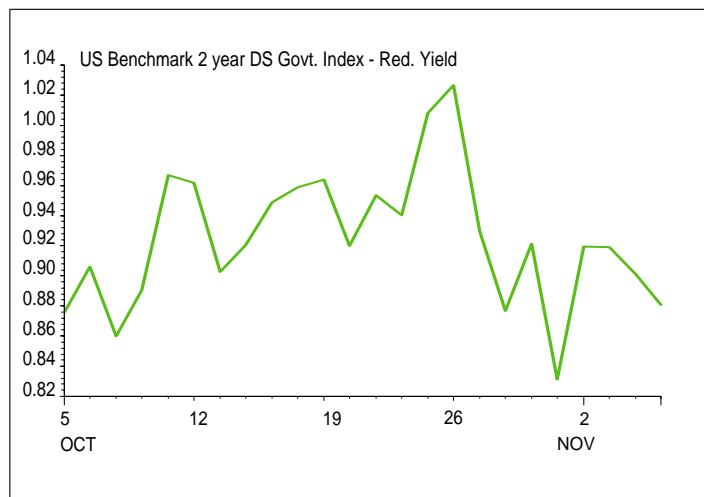


Chart 4: US 10yr yield settles above 3.50%

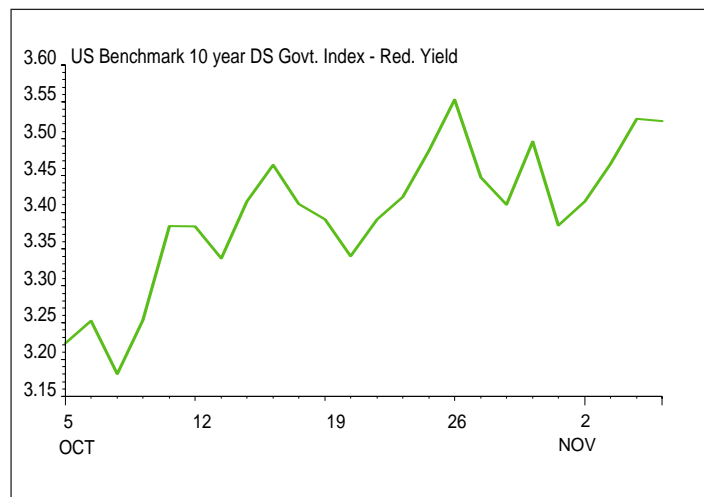


Chart 5: EU-16 2y yields rise on ECB comments

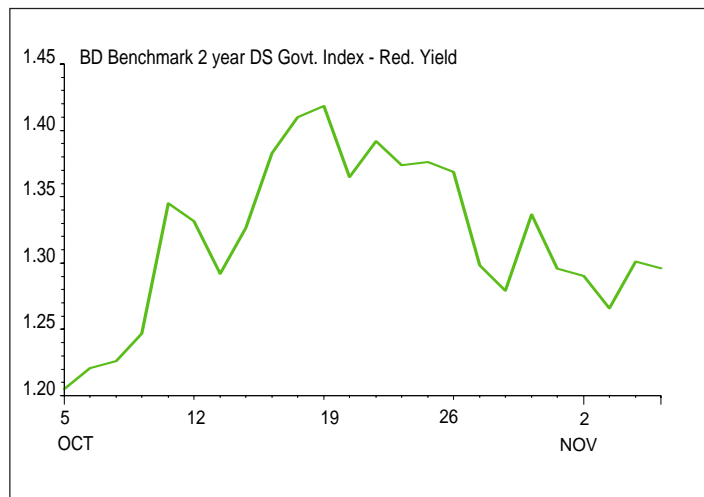
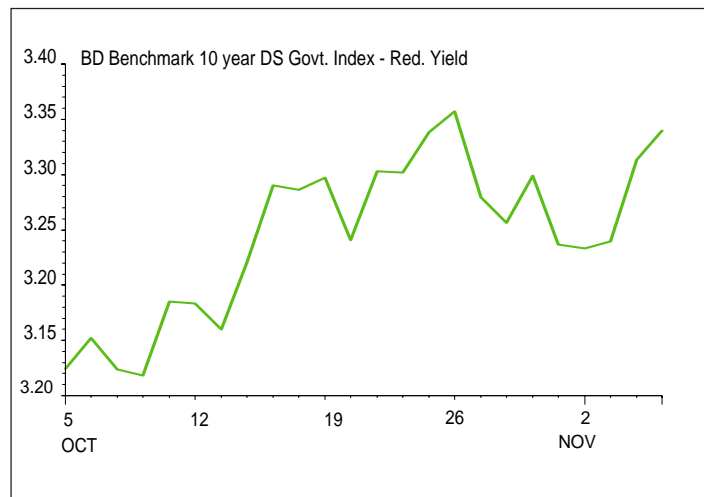


Chart 6: EU-16 10yr yield edges up over 3.30%



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Interest rate markets - graphical analysis of recent trends

Chart 1: US 5yr swap steady at 2.70%

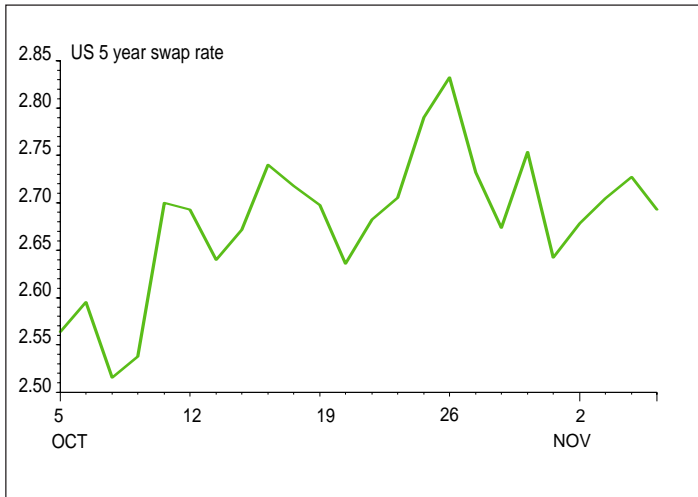


Chart 2: Euro 5yr swap in a range around 2.80%

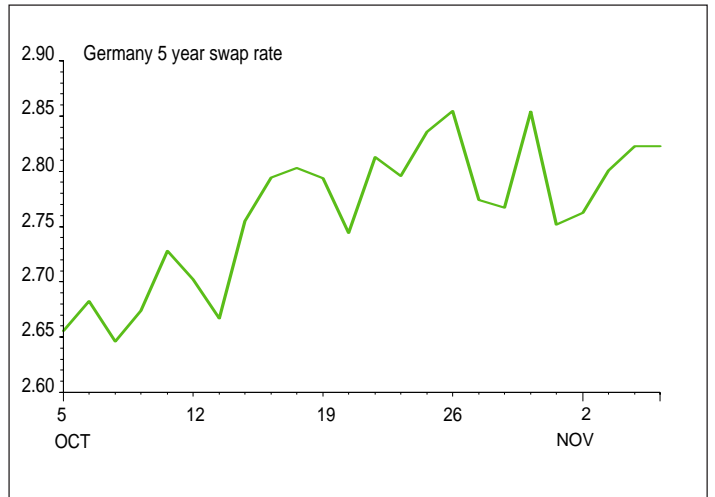


Chart 3: UK 5yr swap rose above 3.40% this week

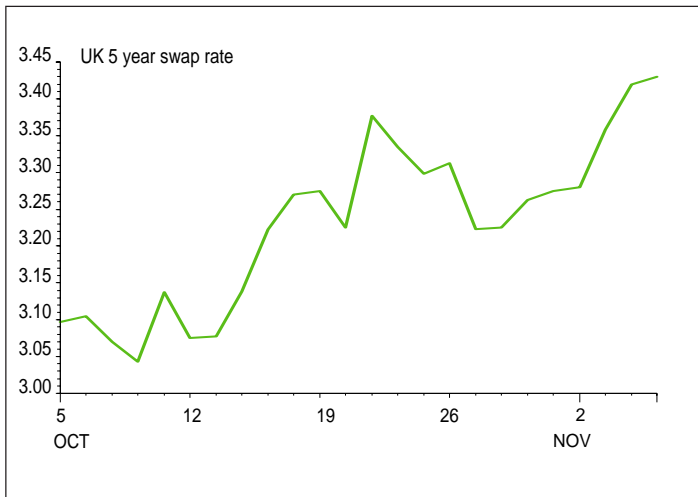


Chart 4: US curve flattens fractionally

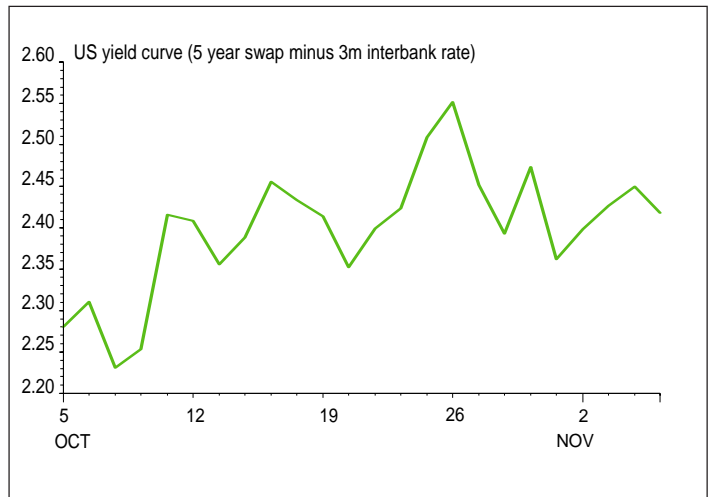


Chart 5: Eurozone spread widens though 210bps

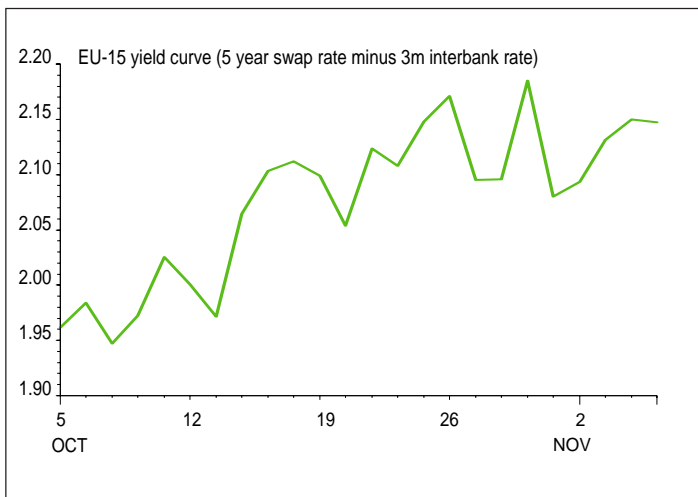
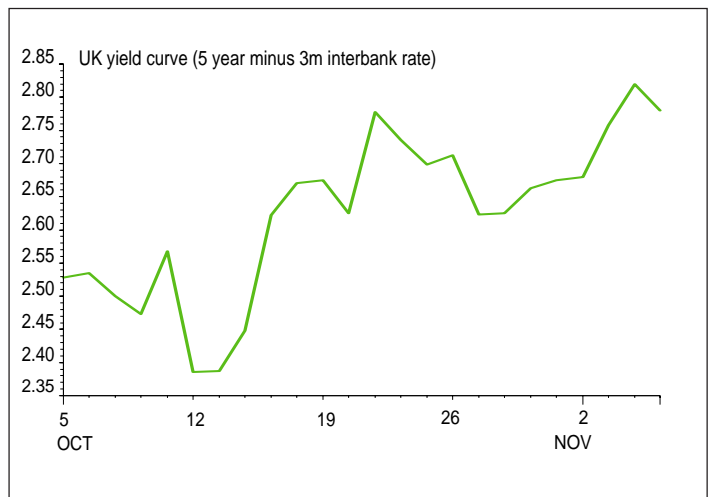


Chart 6: UK curve steepens above 280bps



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

Key commodity and equity markets - Graphical analysis of recent trends

Chart 1: Gold hit \$1,100/troy ounce on Friday

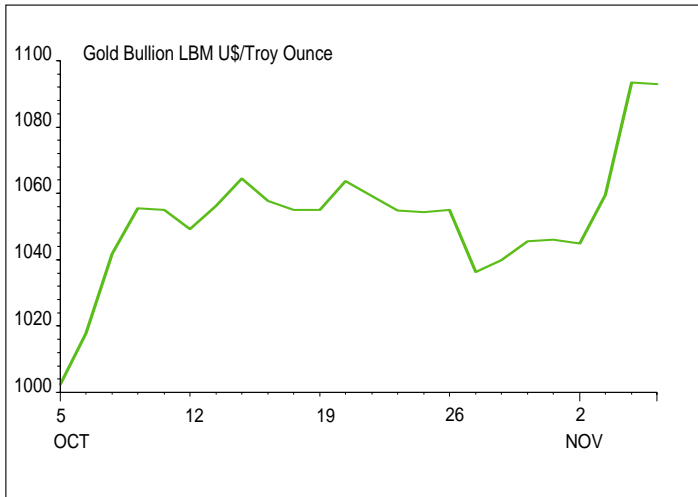


Chart 2: Brent crude oil stable around \$78pb

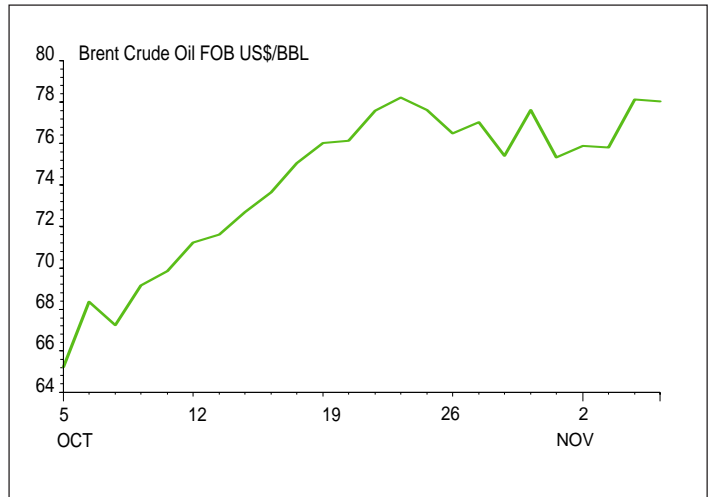


Chart 3: The FTSE-100 rose 2.4% this week



Chart 4: The Dow Jones shrugs off weak US jobs data



Chart 5: Nikkei ends the week below 10,000

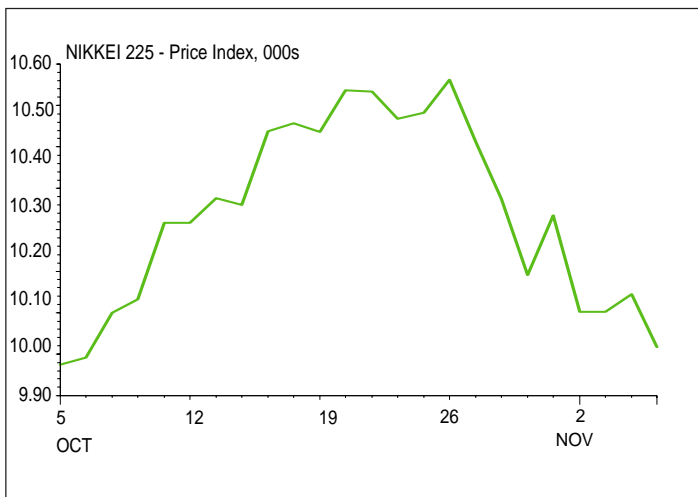
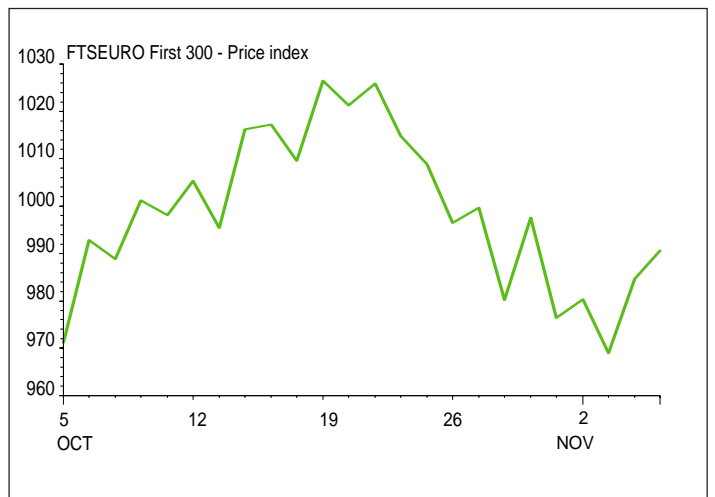


Chart 6: EuroFirst 300 ends the week on a high



Source: Lloyds TSB Corporate Markets Economics and Thomson Datastream

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