



Financial Markets Review

29 September 2006

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Dollar advances on positive US economic data

The Dow traded within striking distance of a new record high this week (11,742). The FTSE-100 rose back above the 6,000 mark, extending its gain to 9.8% since the middle of June.

Gold prices rose back above \$600. Oil prices edged up to \$63 on talk of a cut in Opec output quotas in Q4.

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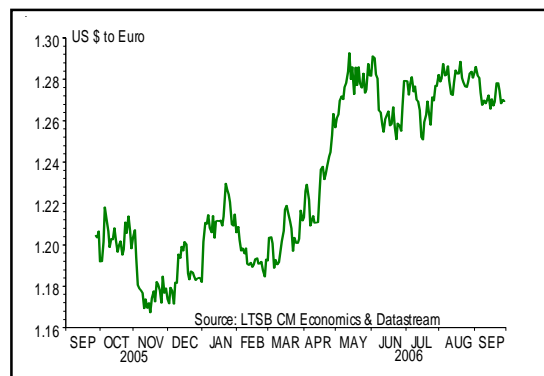
Financial market review - foreign exchange

The dollar strengthened on the foreign exchange markets this week thanks to a sequence of robust economic figures on the US economy. £/\$ was among the biggest casualties with a loss of 1.6%, after the Office for National Statistics (ONS) unexpectedly revised down its estimates for export price inflation and BoE MPC member Blanchflower reiterated his dovish inflation stance. €/€ fell 0.8%, despite stronger than forecast money supply and economic sentiment data from the euro zone which could lead the ECB to raise interest rates twice more this year. Sterling sold off against the euro, falling back to 1.4738, down 1.5% from last week's high of 1.4958. In emerging markets, the South African rand fell to the lowest level since mid July 2003, weakening to 7.78 against the dollar. The Brazilian real was stable ahead of the presidential election this weekend, trading at 2.18 against the dollar and 2.7650 against the euro.

The dollar shrugged off a downbeat report on the US housing market on Monday and strengthened against the euro. A fall in French business confidence and a substantial drop in German CPI inflation to 1.0% in September from 1.7% in August took the shine off the euro rally the previous week.

The dollar extended gains on Tuesday after a stronger than forecast rebound in US consumer confidence in September cast doubts over the likelihood of lower interest rates as soon as Q1 2007. £/\$ fell below 1.8950 during the day, €/€ closed below 1.2700. Sterling lost ground for a second session on Wednesday, slipping below 1.8900 after UK Q2 GDP growth was scaled back to 0.7% from the previous 0.8% estimate, and the ONS revised down its estimates for the annual Q2 GDP deflator to 2.2% from 3.4%. Better than expected

€/€ fell just over 1% this week on good US data



Financial market trends, ending Friday 29 Sept. '06

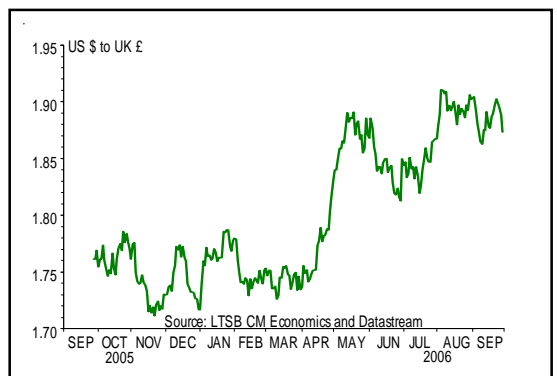
At 4.30pm 29 Sept. '06		Change from 22 Sept. '06 % change
FTSE 100	5956.9	+2.3%
Exchange rates		
US\$/UK £	1.8715	-1.57%
Euro €/UK£	1.4738	-0.78%
US\$/Euro €	1.2699	-0.82%
Swaps - 5 year (mid rate)		
UK pound	5.06	-4.0
US dollar	5.08	+3.0
Euro	3.82	+4.0
Bond yields -10 year		
UK	4.52	+2.0
US	4.64	+2.0
Euro	3.71	+1.0

US new home sales data also attracted dollar buyers.

Comments on Thursday by BoE MPC member Blanchflower that the UK labour market and consumer spending are poised to weaken in the coming months sparked further selling in the major sterling crosses. £/\$ posted its biggest intra-day loss in three weeks, plummeting below 1.8800.

Sterling slumped on Friday for a 4th day in a row after stronger than forecast US inflation data for August and a rebound in manufacturing sentiment in the Midwest left markets guessing about the direction of the next move in US interest rates. £/\$ fell below 1.8650, shedding 0.67% on the day, completing a 2.3% retracement from Monday's 1.9074 intra-day high. Sterling also retreated against the euro on Friday after a rise in euro zone economic sentiment in September to the highest level since February 2001. £/€ fell to 1.4721 on Friday, completing a 1.6% reversal since touching 1.4957 on Tuesday. The JPY also lost in value this week against dollar and euro despite news of a rise in core Japanese inflation to 0.3% in August.

£/\$ fell for three days in a row this week



Interest rate market review - bonds, cash and swaps

Bond markets wrestle with the impact of lower energy costs and the housing market slow-down.

Rolling calendar of UK data releases and events

PPI (9/10)
Trade balance (10/10)
CPI (17/10)
MPC minutes (18/10)
Unemployment (18/10)
Retail sales (19/10)
PSNCR (19/10)

Rolling calendar of US data releases and events

Budget statement (10/10)
Wholesale invent. (10/10)
Beige book (12/10)
Trade balance (12/10)
Retail sales (13/10)
Uni of Michigan conf (13/10)
Empire Manufacturing (16/10)

Central bank meetings in 2006/2007

European ECB (3.00%)
2 November, 7 December, 11 January, 22 February
US FOMC (5.25%) - 24/25 October, 12 December, 30/31 January
UK MPC (4.75%) - 9 November, 7 December, 10 January, 8 February

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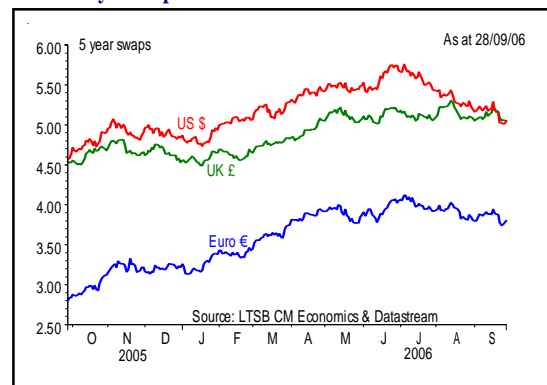
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There was a rather mixed picture for bond yields in the past week. In the US, yields see-sawed, but bond bears appeared to have the upper hand as the weekend approached. Yields rose on a strong-than-expected rebound in US consumer confidence in September, helped by the recent decline in gasoline prices. In addition, the annual core PCE deflator increased to 2.5% in August from 2.3%, above the Fed's 1-2% comfort zone. New home sales for August also rose 4.1% to 1050k, though the trend remains clearly lower in the past year. On Friday, the unexpectedly strong Chicago PMA survey pushed yields decisively higher on the week. On the side of lower yields, the August durable orders data were weaker than expected, recording back-to-back monthly falls, while Q2 GDP was also unexpectedly revised lower to an annualised rate of 2.6% from 2.9%.

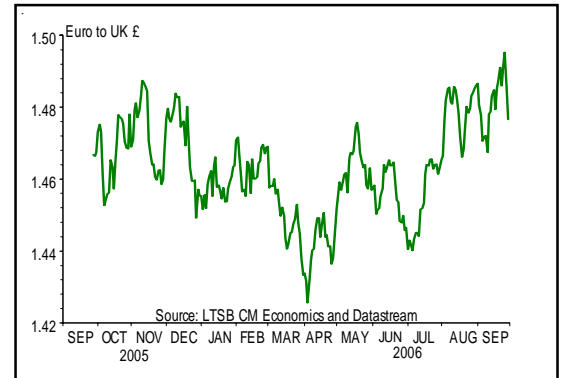
The equity markets appeared to be more positive regarding the US growth outlook than bond markets, thereby implicitly giving greater weight to the positive impact on growth from lower energy prices than on the negative impact of the slowing housing market. Over the week, the Dow made 2006 highs, topping the May 10 high of 11,643. US 10-year yields rose 10bps over the week to 4.64%, though remained well down on 4.85% a month ago. At the short end of the curve, 2-year yields were 2bps higher at 4.69%. Consequently, the 2s/10s spread remained in negative territory, at -5bps, i.e. the yield curve remained downward sloping out from 2 years. Strong demand was seen in the auctions of the 2- and 5-year notes, with steepening trades helping to apply downward pressures on 2- and 5-year yields.

In the euro area, the economic data pointed to firm economic activity at the current time, though there is the possibility of weaker growth ahead. The EC economic sentiment indicator rose to the highest level since February 2001, while the current assessment component of the German Ifo survey increasing to 111.3 from 108.7, the highest since 1991. Further, M3 money supply growth rebounded in August to 8.2%, remaining well above the 4.5% reference value. However, the expectations component of the Ifo survey fell to 98.9 from 101.4, indicating that economic growth may have peaked. In addition, the EU-12 flash CPI estimate fell to 1.8% in September from 2.3%. Nevertheless, we expect CPI inflation to edge

Gloabl 5yr swaps saw little variation this week



£/€ fell 0.8% this week, slipping below 1.4750



higher again in the coming months and ECB speakers in the past week have reaffirmed that policy tightening will continue, with a 25bps rate rise to 3.25% expected next week.

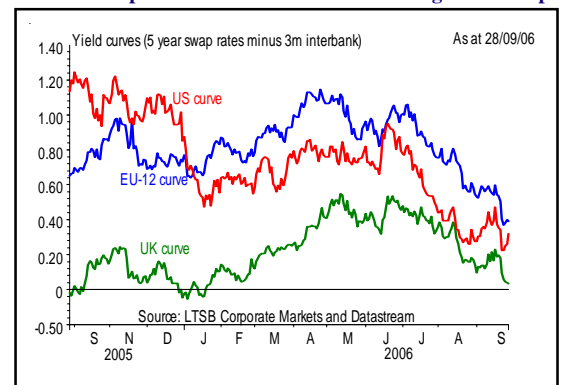
Demand at the 5-year German bond auction was poor, with a bid/cover ratio of only 1.2. Compared with a week ago, German 10-year yields rose 2bps to 3.71%, but remained lower than the month-ago level of 3.83%. The economic data were mixed in the past week, but 2-year yields eventually pushed higher at 3.59%, up 4bps. The 5-year swap rate edged higher by 5bps to 3.83%.

UK bonds outperformed their US and UK counterparts, despite a broadly positive set of numbers for economic growth. Q2 GDP growth was revised down to 0.7% q/q from 0.8%, but this was still a robust pace of growth. The Nationwide said that house prices surged 1.3% in September, bringing up the annual rate to 8.2%. Mortgage approvals data from the Bank of England remained at a historically high level of 119,000, suggesting that housing market activity will remain strong in the coming months. The CBI's distributive trades survey for September was also strong, with the reported sales balance rising to 14 from 12.

A significant portion of the good news for the UK economy had already been priced in and explains the pullback in sterling interest rates last week. Thus, UK 2-year yields fell 2bps to 4.92%, weighed by also dovish comments from the Bank of England MPC's Blanchflower on Wednesday, while 10-year yields rose 2bps to 4.52%.

Hann-Ju Ho
Kenneth Broux

UK curve spread ended the week unchanged at 55bp



FOREIGN EXCHANGE - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: £/\$ lost 2.3% from its intra-week high this week

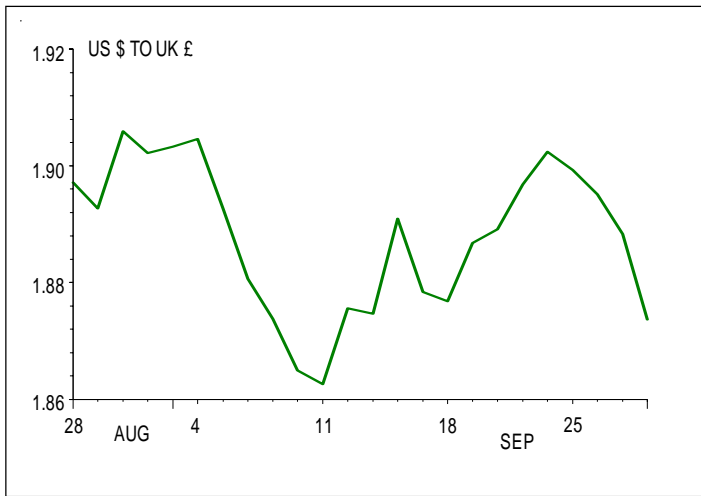


Chart 2: €/\$ fell below 1.2700 ahead of ECB rate decision next week

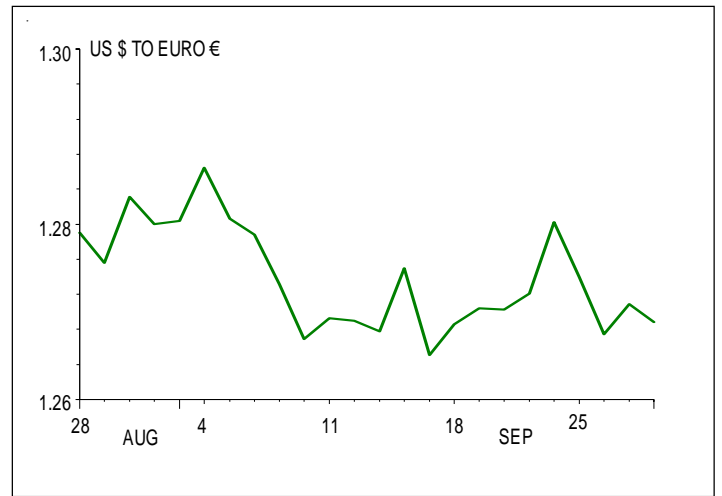


Chart 3: £/€ lost 0.8% on broad sterling selling

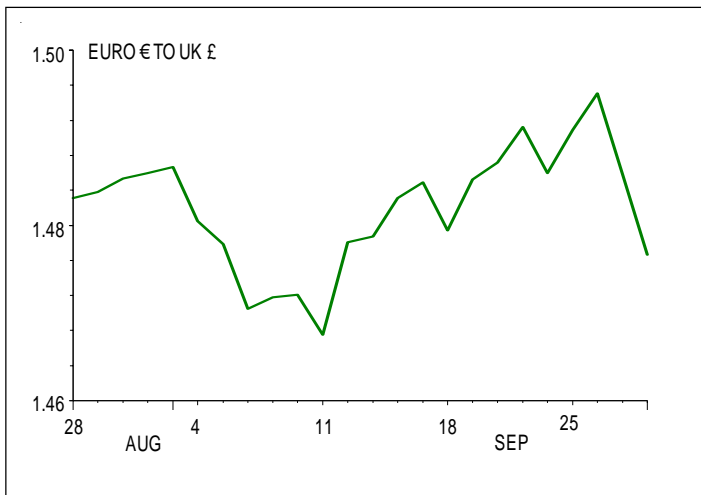


Chart 4: \$/¥ rose back above 118.0 this week

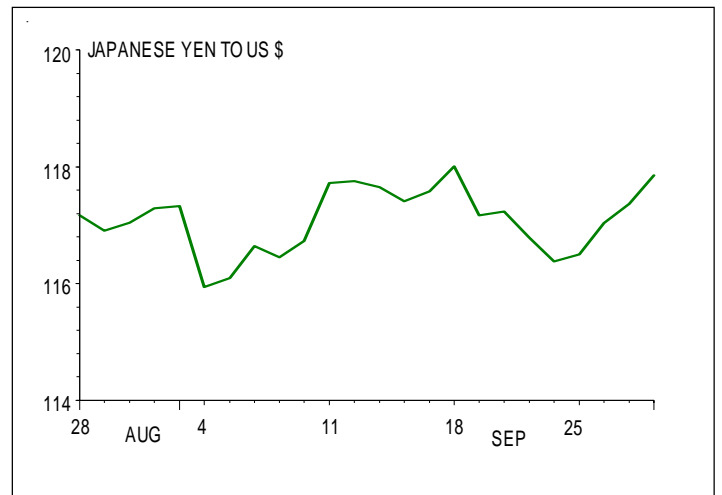


Chart 5: \$/Cad fell to a 3-week low (1.1088)

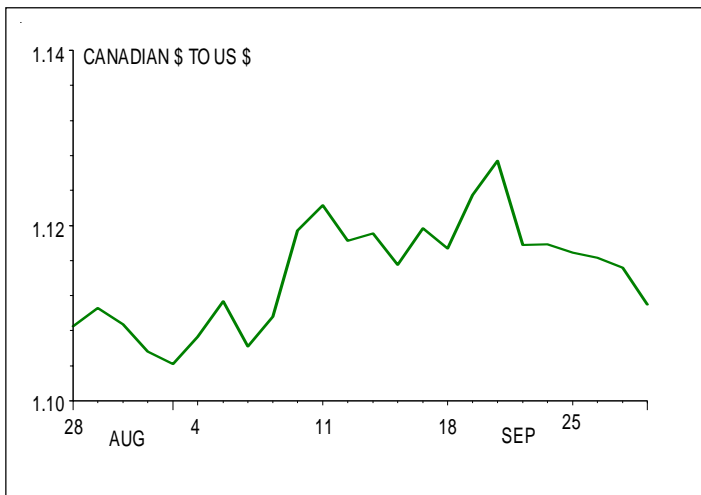
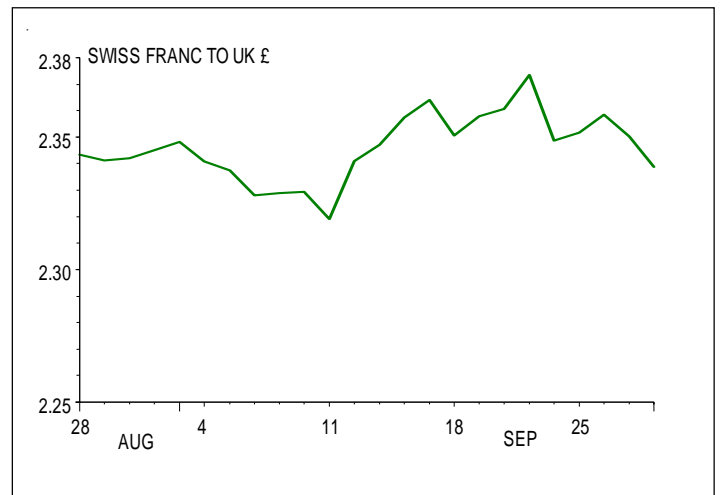


Chart 6: Swissie fell below 2.3400 on Friday



FIXED INCOME - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: UK 2yr yields rebounded from a 2-week low of 4.87%

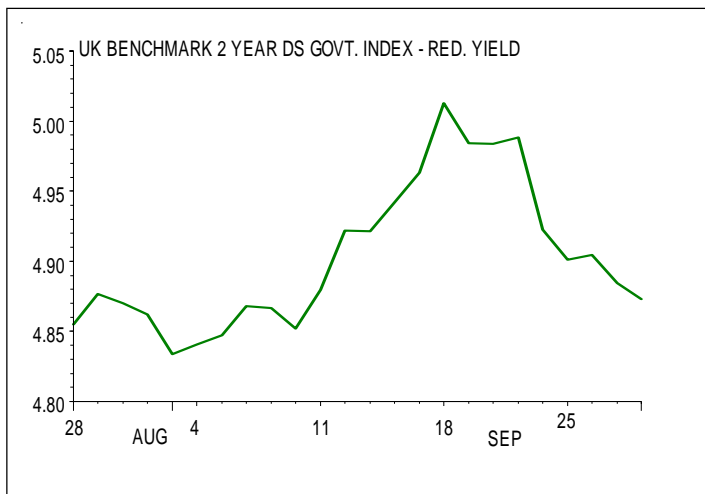


Chart 2: UK 10yr yields rebounded from a 5 1/2 month low of 4.44%

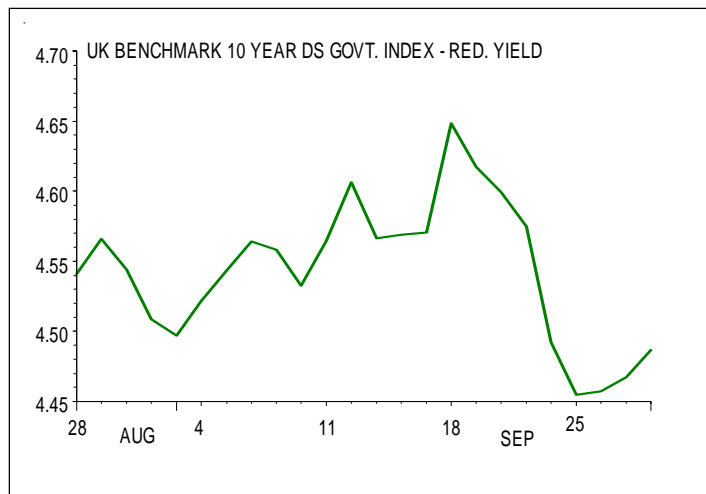


Chart 3: US 2yr yields touched a 6 1/2 month low (4.63%)

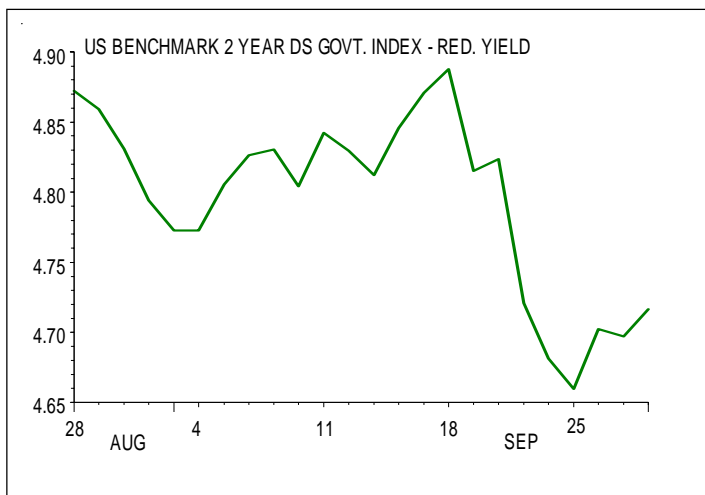


Chart 4: US 10yr yields closed at the week's high of 4.65%

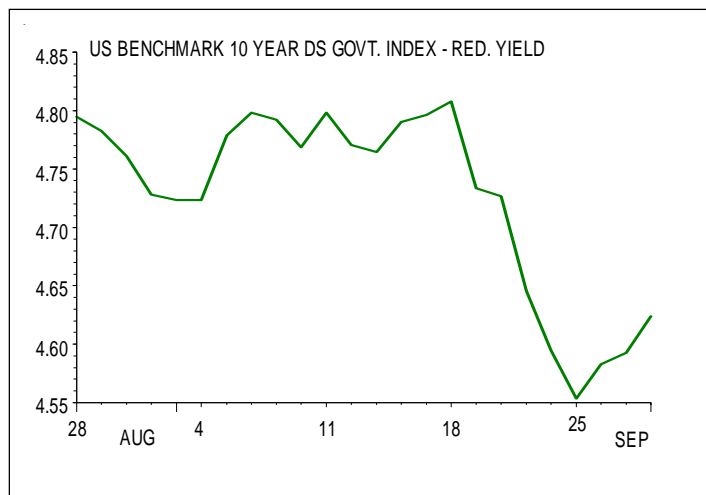


Chart 5: EU-12 2yr yields fell below 3.50%

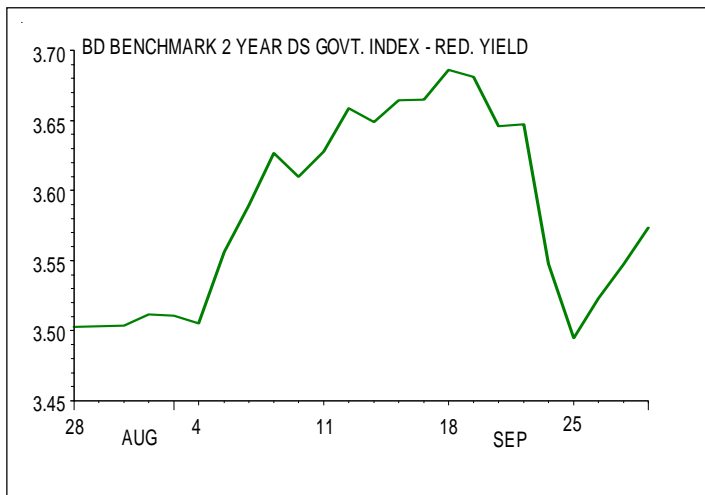
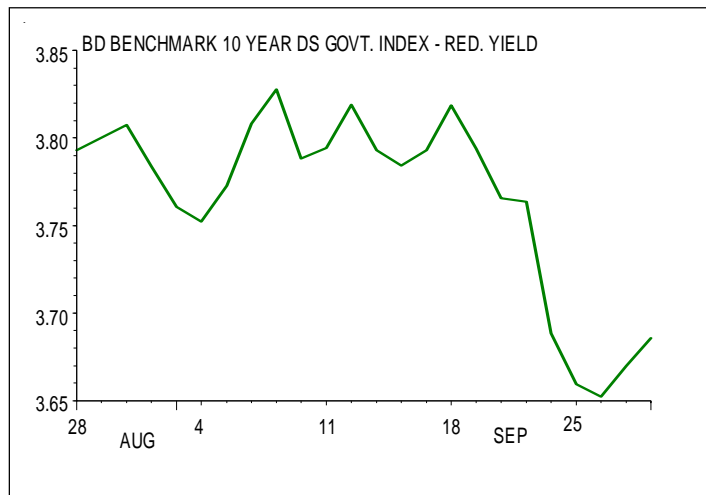


Chart 6: EU-10yr yields fell to a 6-month low (3.64%)



INTEREST RATE MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: US 5yr swaps fell below 5.0%, but rebounded to 5.09%

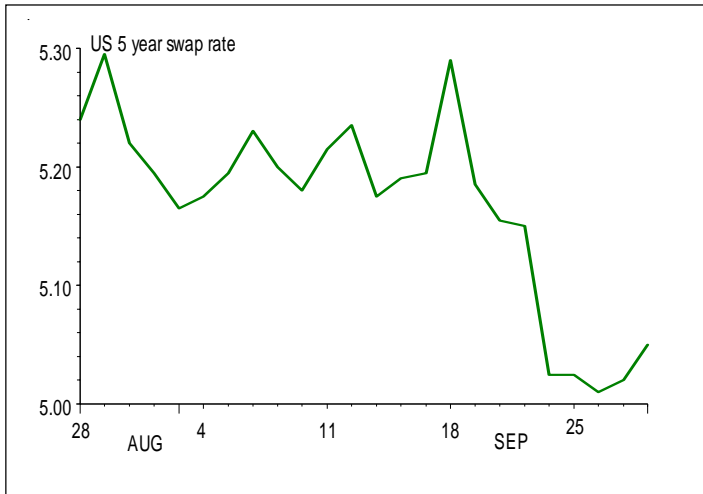


Chart 2: EU-12 5yr swaps rose back above 3.80% on strong data

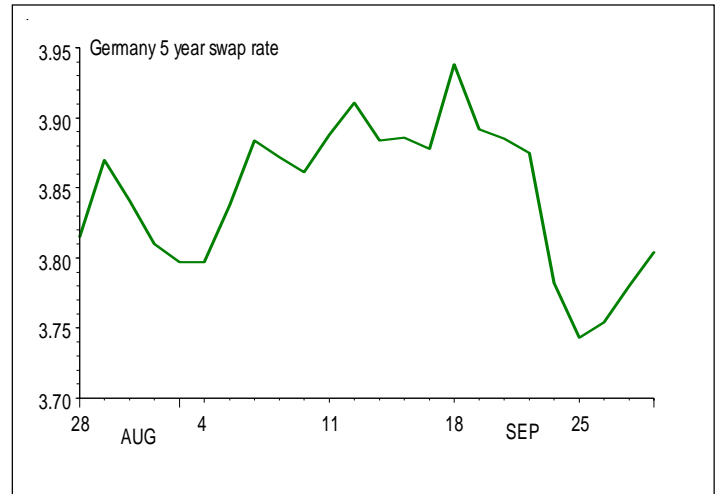


Chart 3: UK 5yr swaps fell to a 3-month low (5.02%)

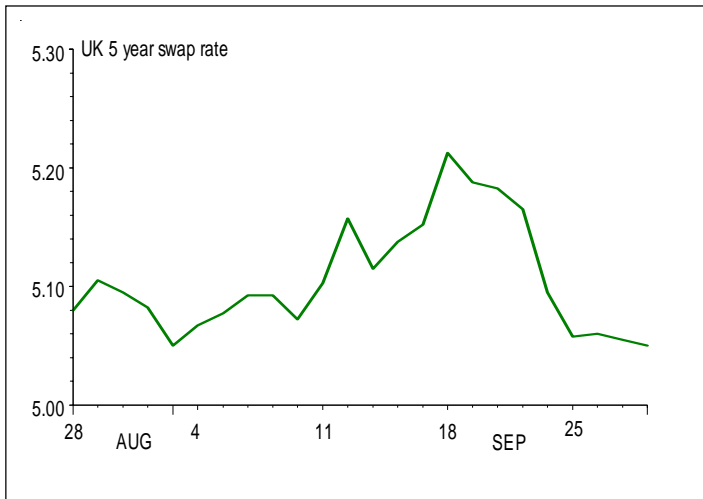


Chart 4: US yield curve steepened this week

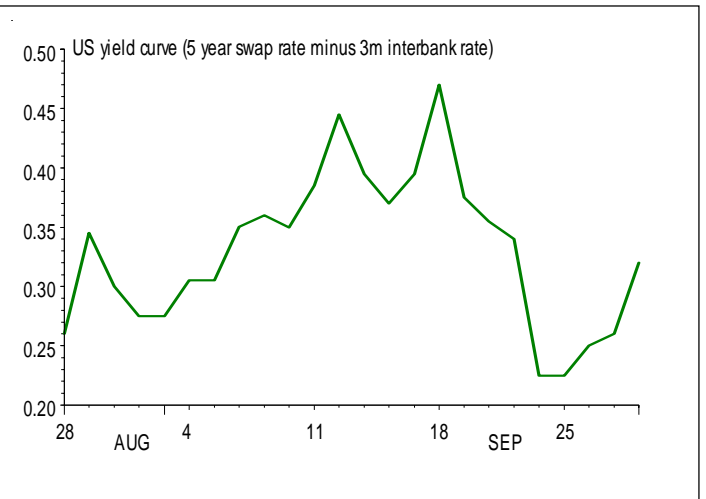


Chart 5: Euro zone yield spread stabilised around 40bp

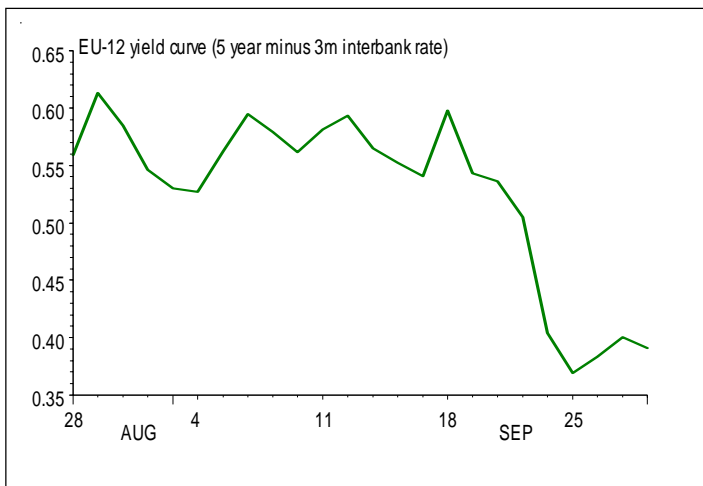
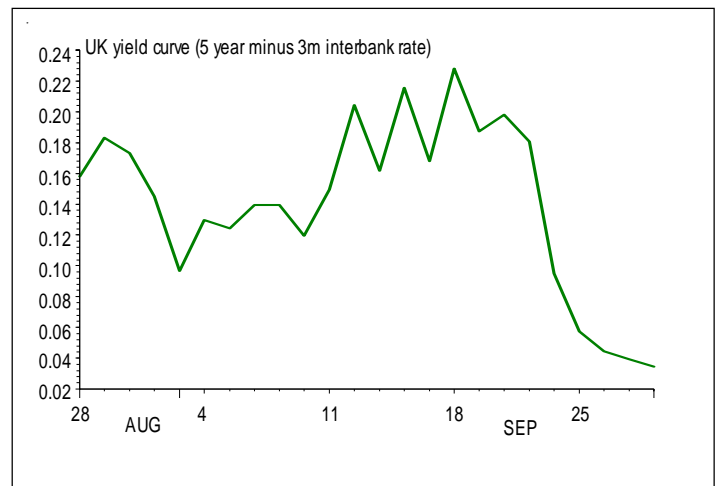


Chart 6: UK yield spread continued to narrow, approaching zero



KEY COMMODITY & EQUITY MARKETS - GRAPHICAL ANALYSIS RECENT TRENDS

Chart 1: Gold prices rose above \$600

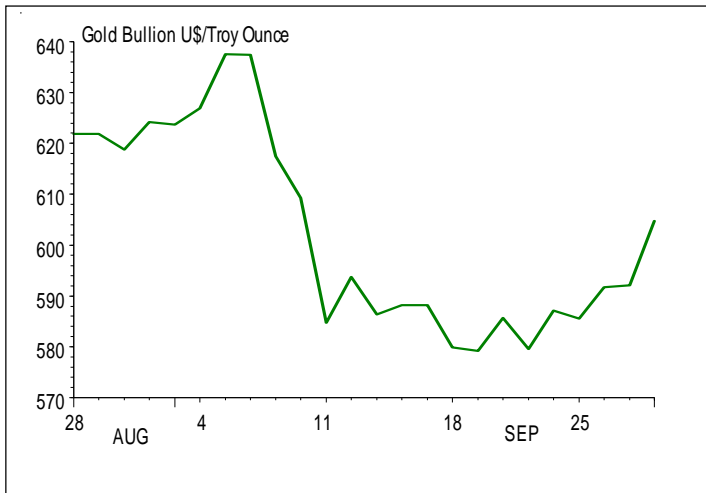


Chart 2: Oil prices rose on talk of cut in Opec output

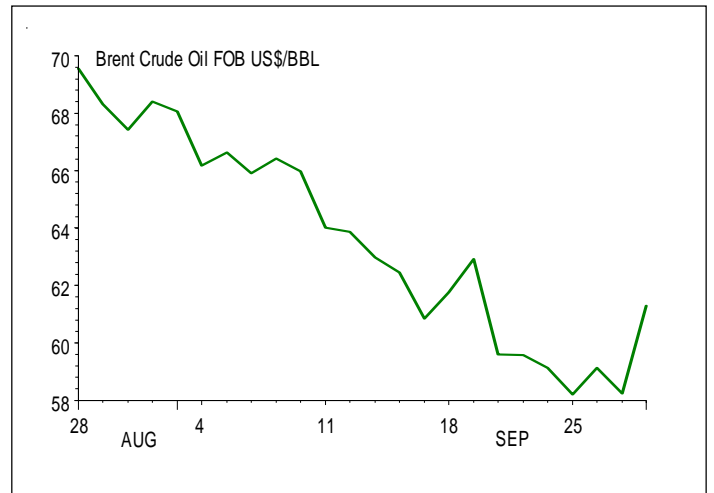


Chart 3: The FTSE 100 rose back above 6,000

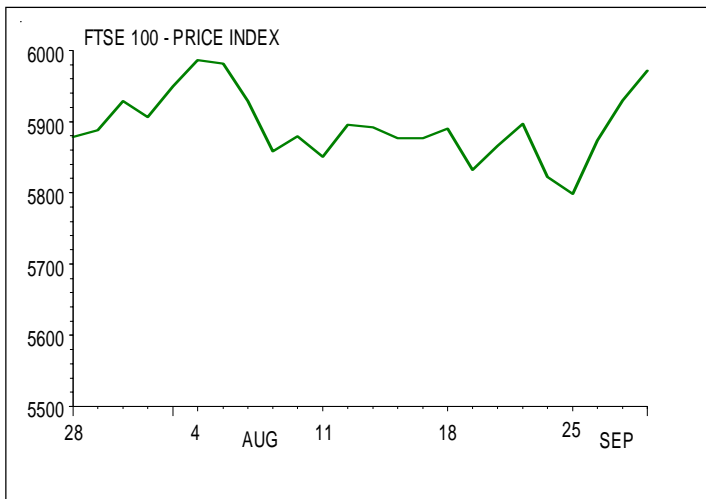


Chart 4: The Dow touched a new all-time high (11,742)

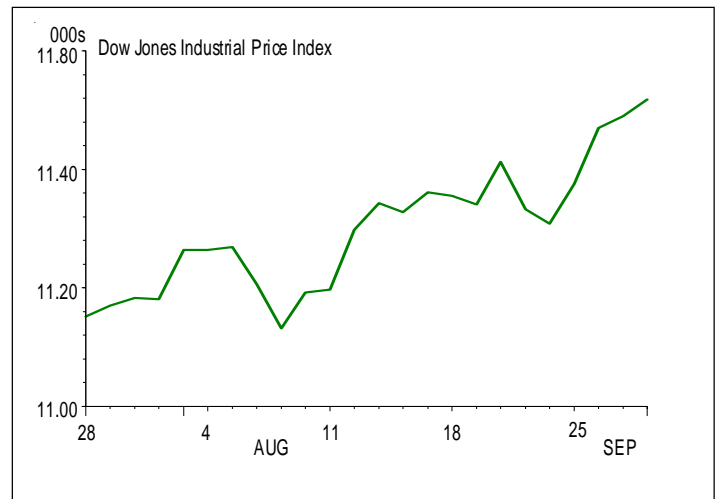


Chart 5: Nikkei-225 rebounded above 16,000

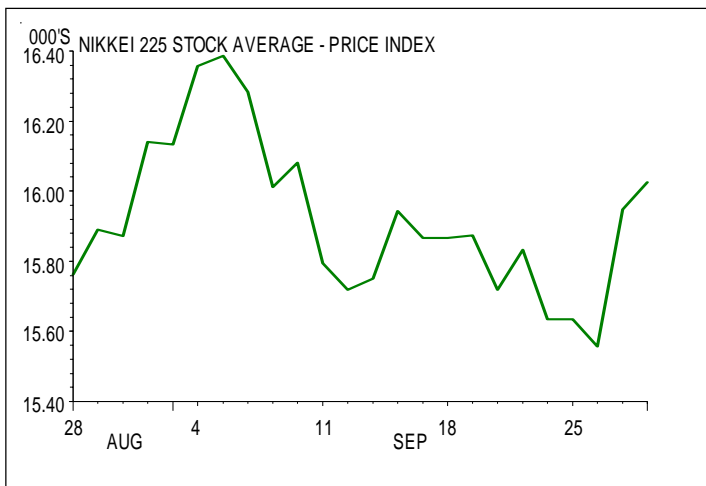
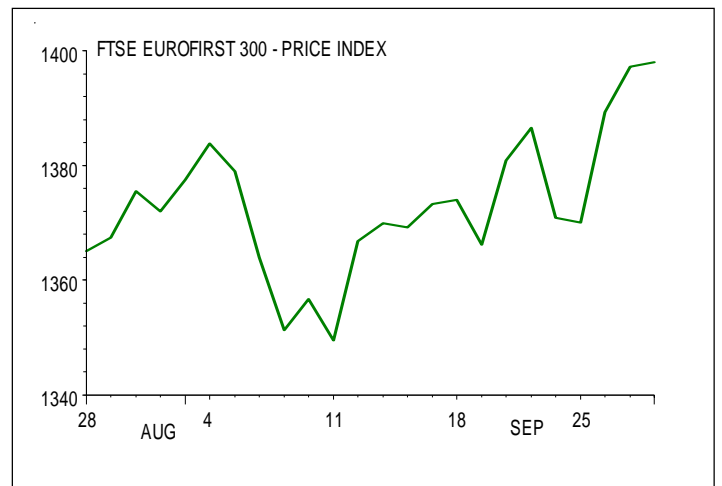


Chart 6: EU-12 equities tracked overseas indices higher



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