



6 October 2006

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Financial Markets Review

UK interest rates held at 4.75%, EU-12 rates rise to 3.25%

The dollar strengthened this week following a strong US labour market report for September.

Global equities had a solid week, the Dow closed at a record high (11,866.7). The FTSE-100 closed above 6,000 for the first time since May. The Eurofirst 300 index rallied to a five-year high (1410.1).

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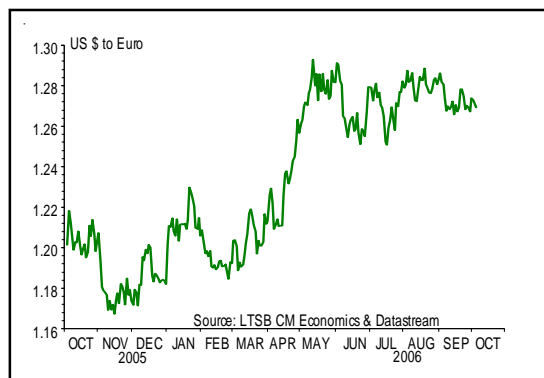
Financial market review - foreign exchange

Interest rate expectations continued to dictate trends in foreign exchange this week. Central bank decisions in the euro zone, UK and Australia provided no real surprises. Tension was highest ahead of the BoE decision, as the outcome appeared to be the most finely balanced. However, base rates were left at 4.75% for a second successive month, in line with the market consensus. The outturn weighed on sterling and pushed it lower against its main trading partners on Thursday. As widely expected, the ECB raised interest rates to 3.25% later on Thursday, prompting only limited market reaction. However, ECB president Trichet then failed to signal a rate hike at the next meeting in November at the news conference and the euro edged lower. Over the week, £/\$ closed 0.2% higher at 1.8711 but €/€ fell 0.6% to 1.2597. £/€ ended the week up 0.7% at 1.4853. Interest rates were kept at 6% in Australia and that led A\$/US\$ to dip to its lowest since June (0.742).

The US labour market report on Friday provided a volatile close to the week after it showed fewer than expected payroll gains in September, leading to a rapid sell-off in the dollar. However, selling quickly reversed as the detail showed a surprise fall in the unemployment rate to 4.6%, rising average earnings and a large upward revision to August payrolls. The dollar rallied to its week highs against the euro (€/\$ 1.257) and yen (\$/Y 119.1), as financial market expectations of an early US interest rate cut were pared back.

Earlier in the week, speeches from Fed members Kohn and Plosser cautioned listeners not to underestimate the Fed's anxiety over inflation and that this rather than growth was their main concern. Their comments outweighed softer than expected outturns for ISM survey reports for manufacturing and services activity in September and a warning on the housing market in a

€/\$ fell below 1.26 this week after US jobs data



Financial market trends, ending Friday 6 Oct. '06

At 4.30pm 6 Oct. '06		Change from 29 Sept.'06 % change
FTSE 100	6001.2	+0.68%
Exchange rates		
US\$/UK £	1.8711	+0.17%
Euro €/UK£	1.4853	+0.73%
US\$/Euro €	1.2597	-0.61%
Swaps - 5 year (mid rate) basis points		
UK pound	5.16	+7.0
US dollar	5.13	+5.0
Euro	3.86	+3.0
Bond yields -10 year		
UK	4.57	+5.1
US	4.68	+5.1
Euro	3.76	+4.9

speech from Fed chairman Bernanke. We believe interest rates will stay on hold at 5.25% until mid-2007, with a possibility that there could yet be another hike.

Although interest rates were maintained at 4.75% in the UK, economic data released this week supported our view that they will rise to 5% in November. The manufacturing PMI rose to 54.4 in September, the output component of which was the highest since July 2004. The services PMI was 57.0 in September, from 56.7 in August. Official industrial output rose by 0.1% in August, underpinned by a 0.4% rise in manufacturing, and should contribute to economic growth in Q3. Sterling could make further gains in coming weeks.

The outlook for euro zone interest rates later this year appear less clear, although financial markets remain of the view that they will rise to 3.5% in December. EU-12 PMI data this week for manufacturing and services activity were weaker than expected for September and we believe Q3 economic growth will be less than 0.9% in Q2. Interest rates remain on an upward curve but the next rise may take place in early 2007. The news conference at the November ECB meeting may be crucial to the euro's prospects in the final quarter of 2006.

£/\$ held its ground on UK rate outlook



Interest rate market review - bonds, cash and swaps

The Bank of England kept interest rates on hold this week. However, a 25bp rise at the November MPC meeting appears very likely

Rolling calendar of UK data releases and events

CPI (17/10)
MPC minutes (18/10)
Unemployment (18/10)
Retail sales (19/10)
PSNCR (19/10)
Q3 GDP (20/10)
M4 money supply (30/10)

Rolling calendar of US data releases and events

Empire Manuf. (16/10)
PPI (17/10)
Industrial prod. (17/10)
CPI (18/10)
Philadelphia fed. (19/10)
FOMC decision (25/10)
Q3 GDP (27/10)

Central bank meetings in 2006/2007

European ECB (3.25%)
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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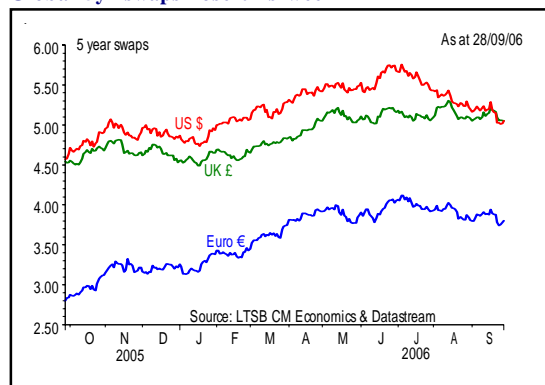
Government bond yields rose across the major economic regions this week after the ECB raised interest rates and a solid US employment report boosted confidence in the economy and dampened speculation of a cut in US interest rates early next year. UK gilts were unfazed by the BoE decision to leave interest rates on hold at 4.75%.

Bond prices fell and yields rose in the UK over the early part of the week in the wake of a stronger manufacturing PMI survey. The manufacturing PMI survey rose to 54.4 in September from 53.0 in August. The output index jumped to 58.7 from 54.2 in August, the highest level since July'04. This reinforced the prospect of gains in manufacturing activity this autumn. A dip in the output prices component eased some inflation concerns and suggests that the pace of price increases seen this year has stabilised. 2yr gilts closed at 4.98% on Tuesday, up 6bp from Friday's 4.92% close. 10yr yields finished at 4.56%, up 4bp. Also on Tuesday, the DMO successfully sold £2.25bn worth of 2027 gilts carrying a 4.25% coupon. The auction was covered 1.86 times, better than the 1.51 times at the previous 2027 auction.

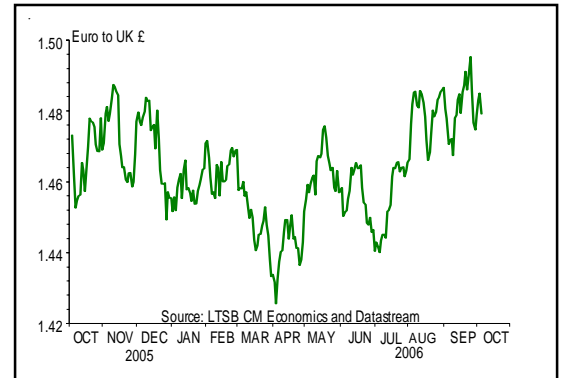
Gilts erased losses on Wednesday despite a better outcome for the services PMI. Gains in business expectations and employment components suggest activity in the sector remains very firm and consistent with an increase in services output in the third quarter of 0.9%. Short and longer dated yields fell on the news to 4.96% (2yr) and 4.53% (10yr), respectively. On Thursday, the BoE kept interest rates unchanged at 4.75% for a second successive month. The decision was widely expected and as a result failed to stir the gilt market. Yields rebounded on Friday in the wake of positive UK manufacturing data for September and a good US employment report. Manufacturing output rose by 0.4%, a fourth successive daily gain. 2yr gilt yields ended the week up 5bp at 4.97%, 10yr yields finished up 4bp at 4.56%. 5yr swaps rose 7bp to 5.16%.

Treasury yields fell to their intra-week lows on Wednesday, as investors bid up prices on a set of weaker economic data, including the manufacturing and services ISM surveys. Both surveys hinted at a slower pace of activity in manufacturing and services sectors at the end

Global 5yr swaps rose this week



£/€ rose 0.73% to 1.4853



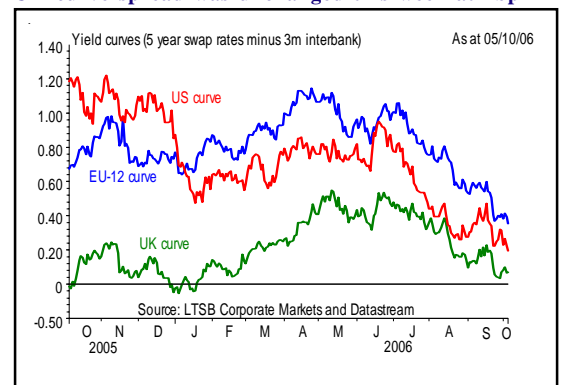
of the third quarter. Weak labour market surveys from a number of sources and comments by Fed Chairman Bernanke that the slowdown in the US housing market would reduce GDP growth in the second half by one percentage point also attracted buyers of fixed income paper. 2yr yields fell on Wednesday to 4.58%, the lowest since February 8th, as speculation of a rate cut in the first quarter of 2007 intensified. 10yr yields closed at 4.56% on Wednesday.

The report on Thursday of a surprise drop in weekly initial claims of 17,000 in the latest week marked the turning point for the treasury market. Losses widened on Friday after the report of a drop in the US unemployment rate to 4.6% in September and a rise in annual wage growth to 4.0%, the highest since September 1998, forced market participants to rein in their optimism that US interest rates will be cut early next year. Heavy selling sent prices of treasury securities tumbling, squeezing yields higher across all maturities. 2yr rates rose 8bp to 4.73%, 10yr yields shot up 7bp to 4.67%. 5yr swaps finished the week 5bp higher at 5.13%.

Euro zone bonds were steady all week, barely reacting to the ECB decision to raise interest rates to 3.25%. However, president Trichet left no doubt about the intention to increase interest rates again if the euro zone economy continues to grow as expected. Bunds fell on Friday, tracking overseas losses due to upbeat US labour market data. 2yr yields closed the week flat at 3.59%, 10yr yields closed up 5bp at 3.76%. 5yr swaps closed 3bp higher at 3.86%.

Jeavon Lolay, Senior Economist
Kenneth Broux, Economist

UK curve spread was unchanged this week at 7bp



FOREIGN EXCHANGE - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: £/\$ briefly fell below 1.8700 on Friday

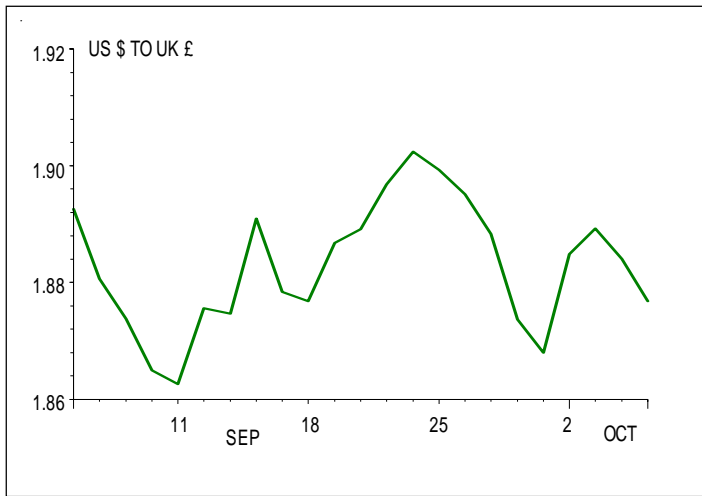


Chart 2: €/\$ fell to 1.2573, lowest since July 26th

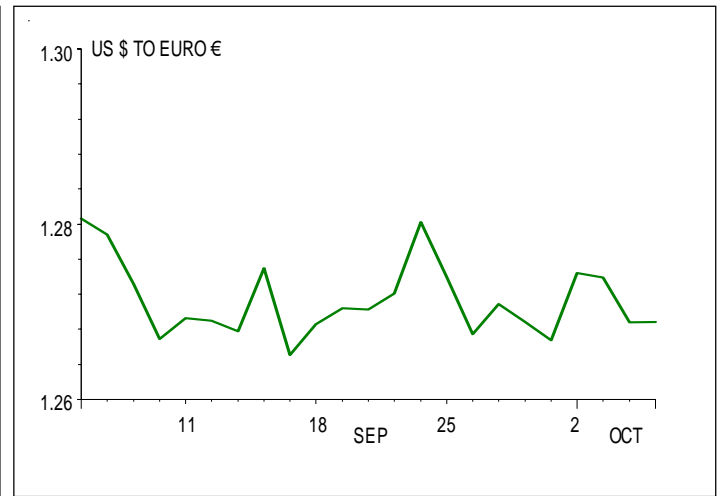


Chart 3: £/€ narrowly missed a break above 1.4900 this week

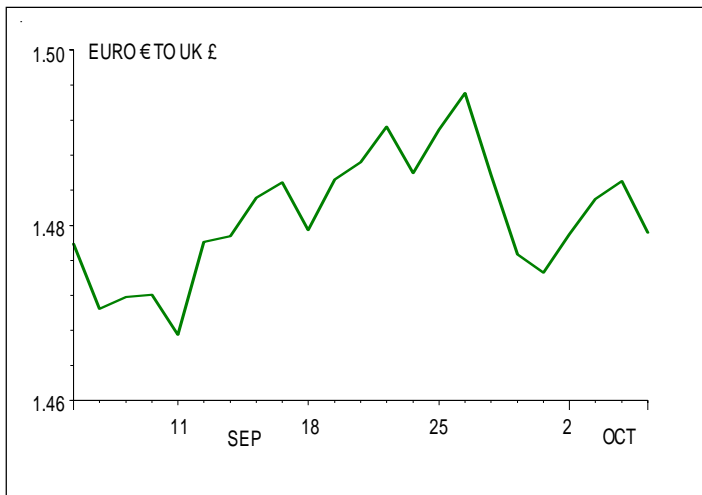


Chart 4: \$/¥ rose the highest level since March 13th (119.10)

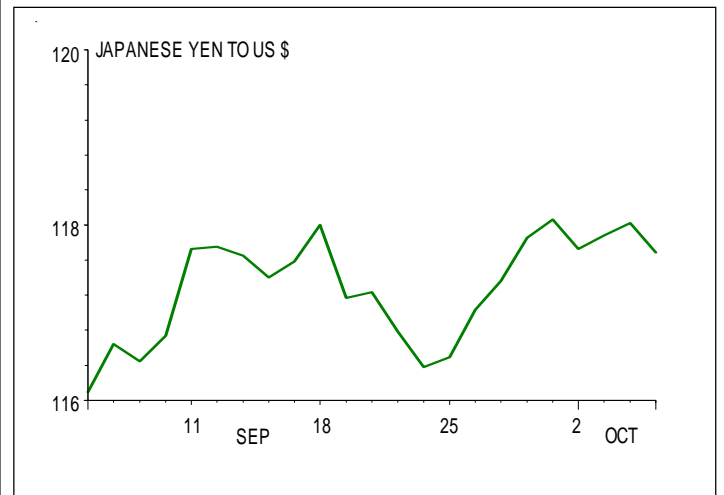


Chart 5: \$/Cad touched highest level since mid-August (1.1307)

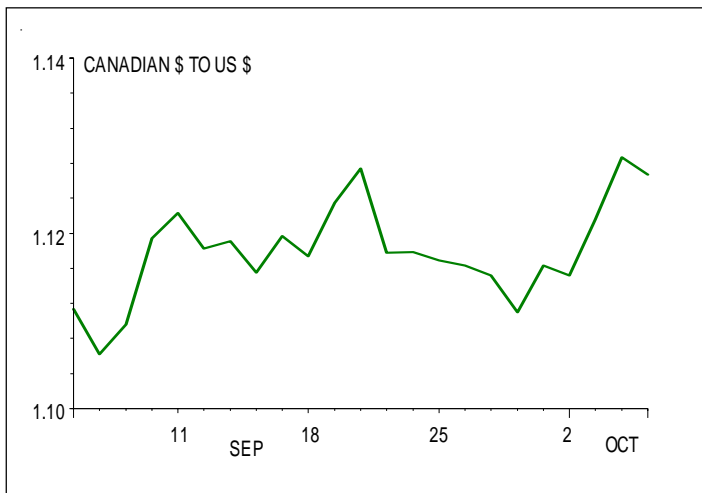
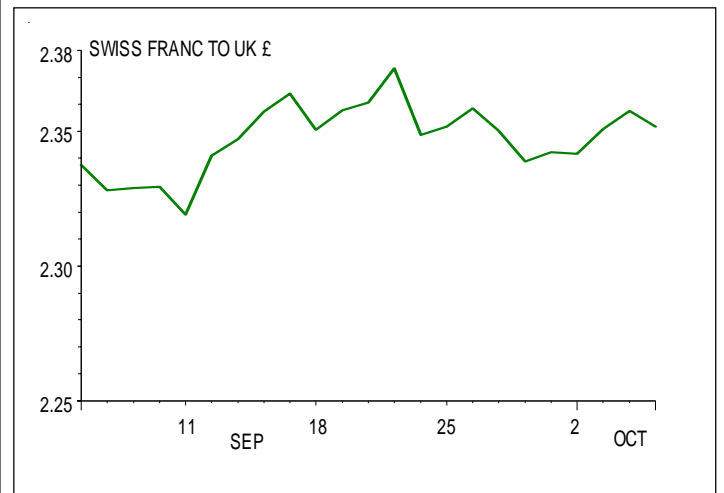


Chart 6: Swissie touched a 2-week high (2.3659)



FIXED INCOME - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: UK 2yr yields approached the 5% level on Friday

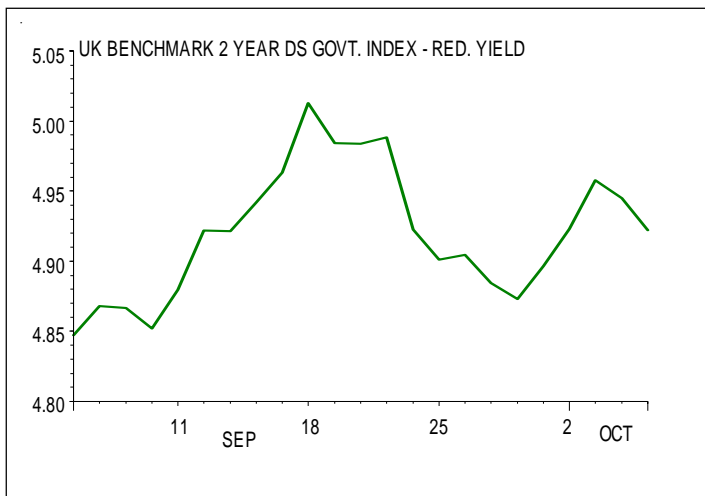


Chart 2: UK 10yr yields settled above 4.55%

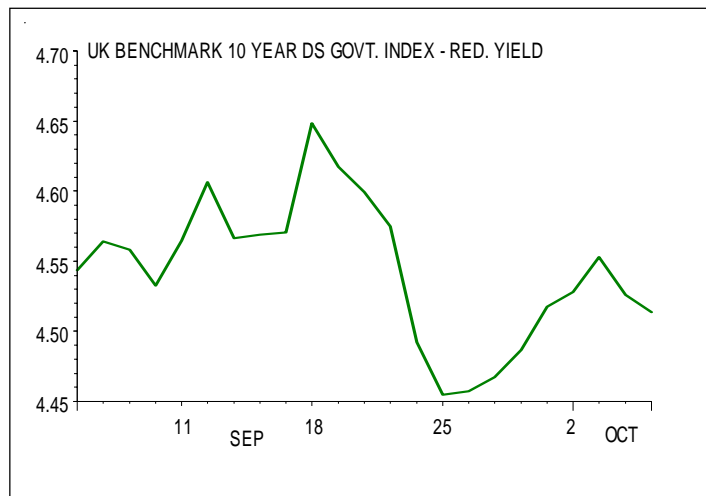


Chart 3: US 2yr yields jumped 8bp to 4.73% on Friday

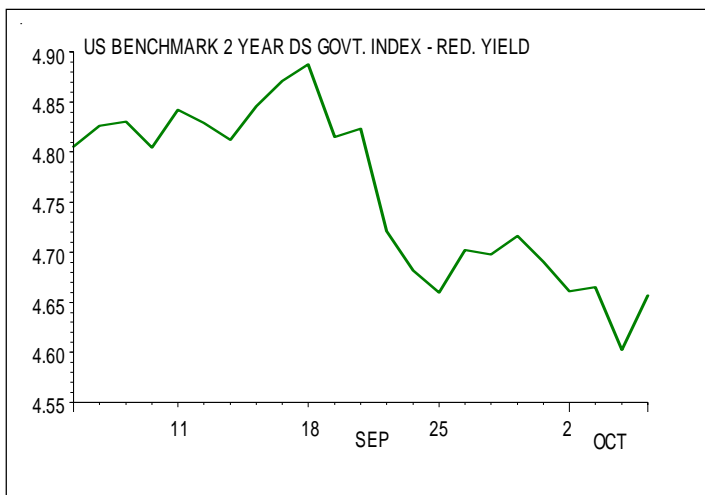


Chart 4: US 10yr yields rebounded off a 4.56% low

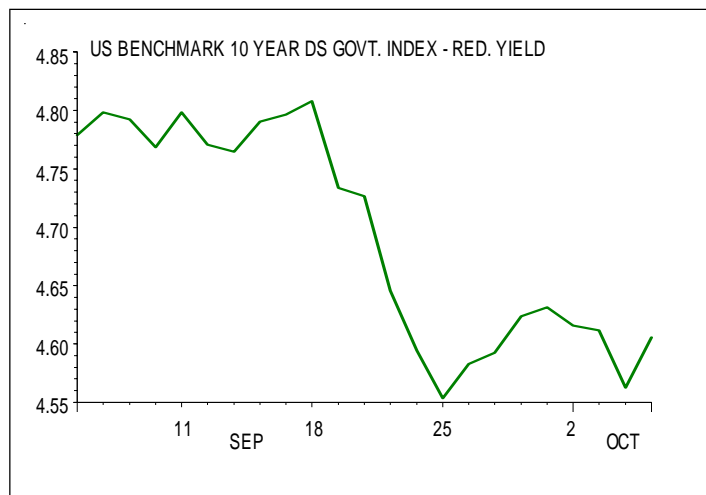


Chart 5: EU-12 2yr yields are priced for one more ECB rate rise

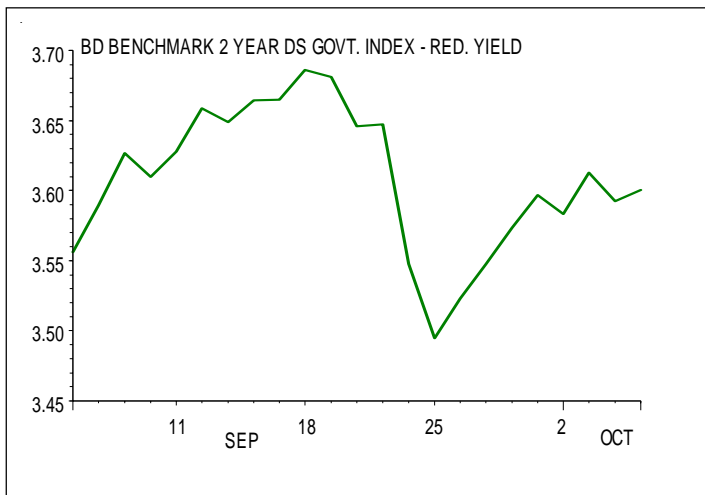
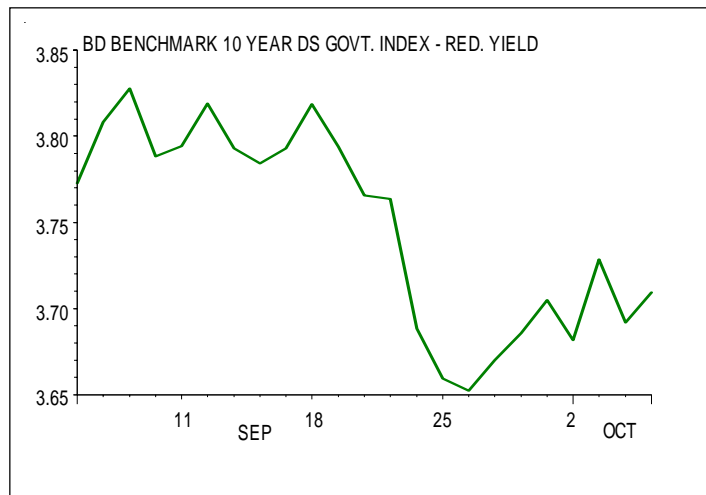


Chart 6: EU-10yr yields were rangebound all week



INTEREST RATE MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: US 5yr swaps rose 5bp to 5.13%

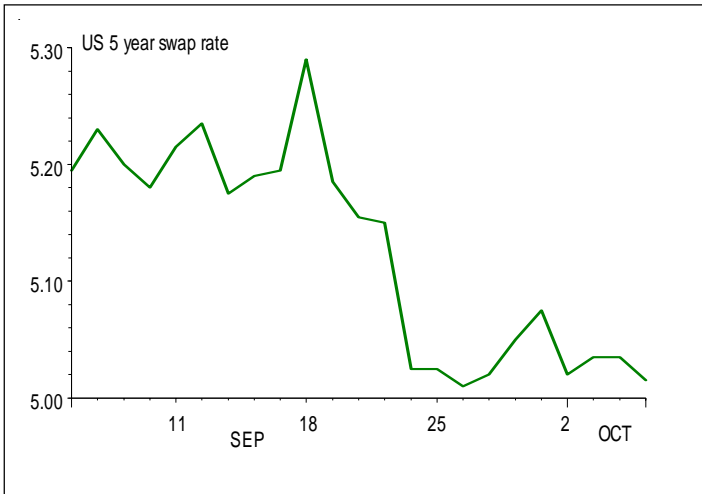


Chart 2: EU-12 5yr swaps edged up 3bp to 3.86%

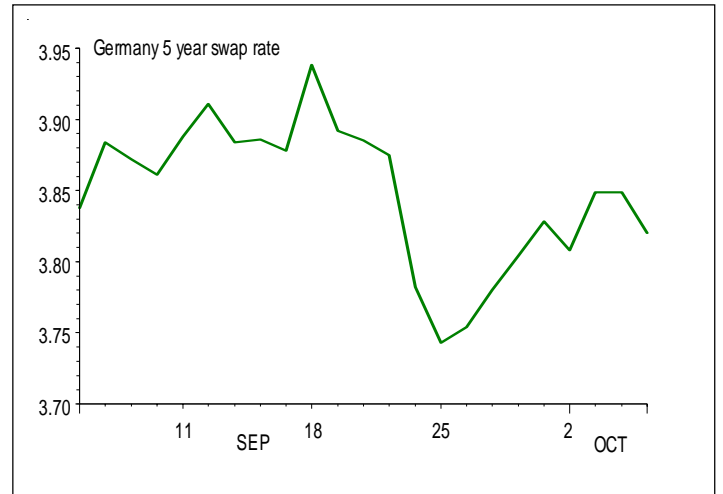


Chart 3: UK 5yr swaps rose 7bp to 5.16%

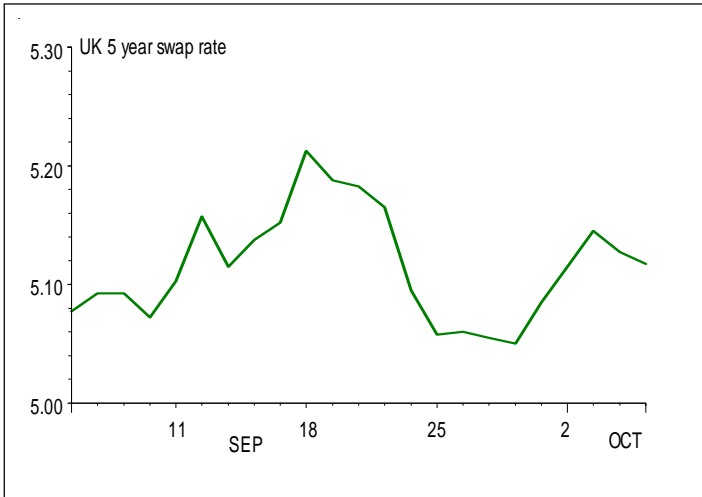


Chart 4: US yield curve flattened this week

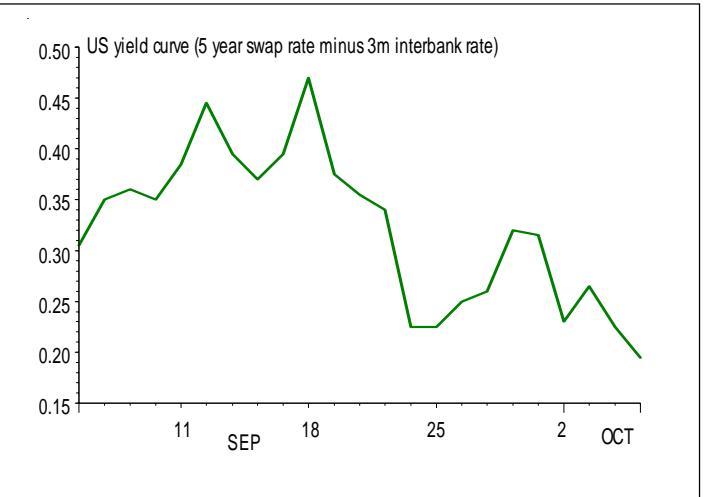


Chart 5: Euro zone yield curve flattened following ECB rate rise

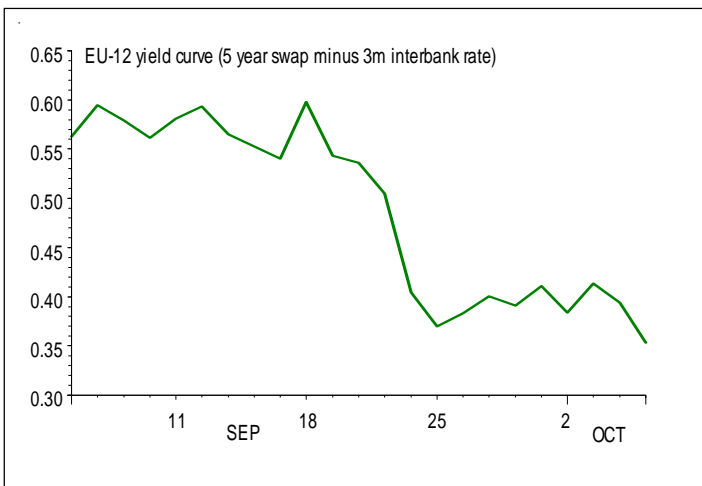
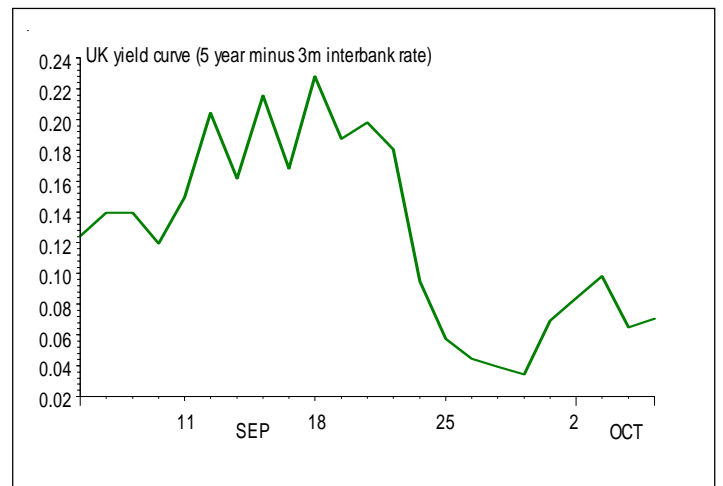


Chart 6: UK yield spread remains close to zero



KEY COMMODITY & EQUITY MARKETS - GRAPHICAL ANALYSIS RECENT TRENDS

Chart 1: Gold prices fell below \$560, lowest since June 20th

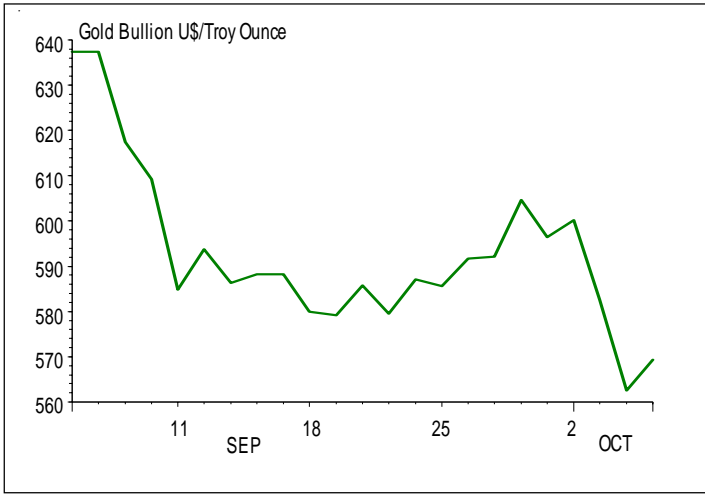


Chart 2: Oil prices fell to \$57.75, extending the downtrend

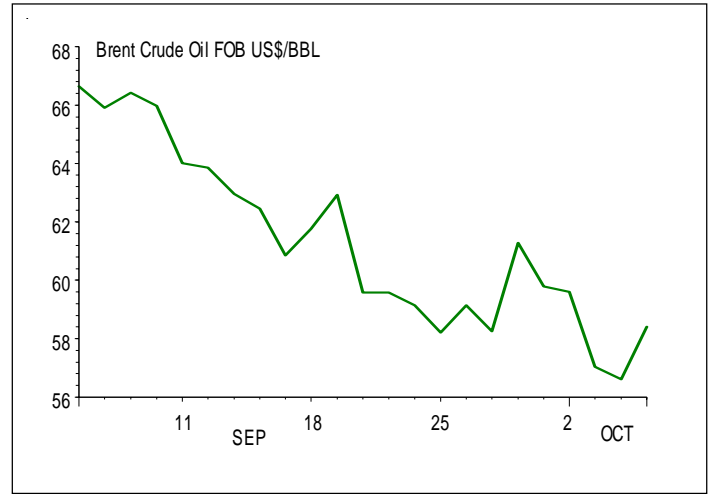


Chart 3: The FTSE 100 closed above 6,000

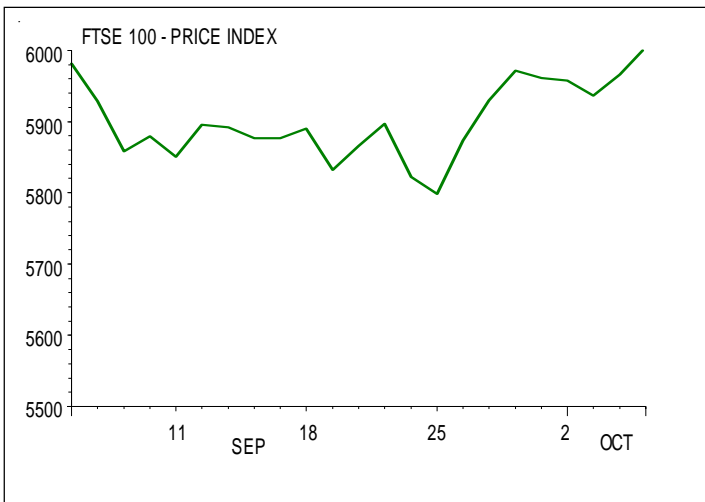


Chart 4: The Dow closed at a new all-time high (11,866.7)

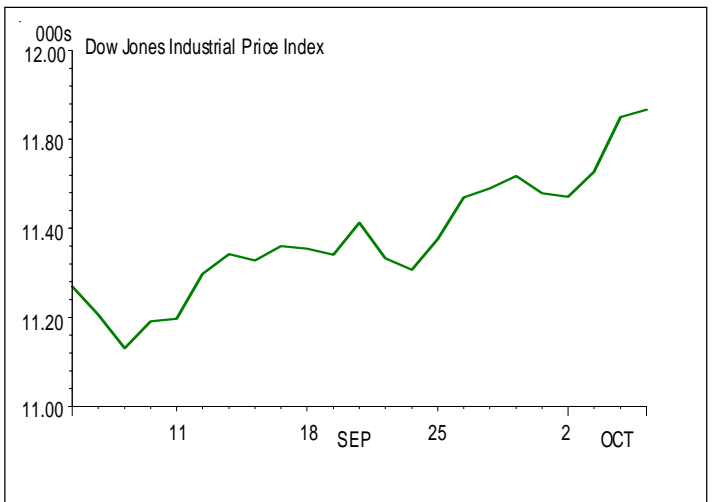


Chart 5: Nikkei-225 rose to 16481.3, highest since May 16th

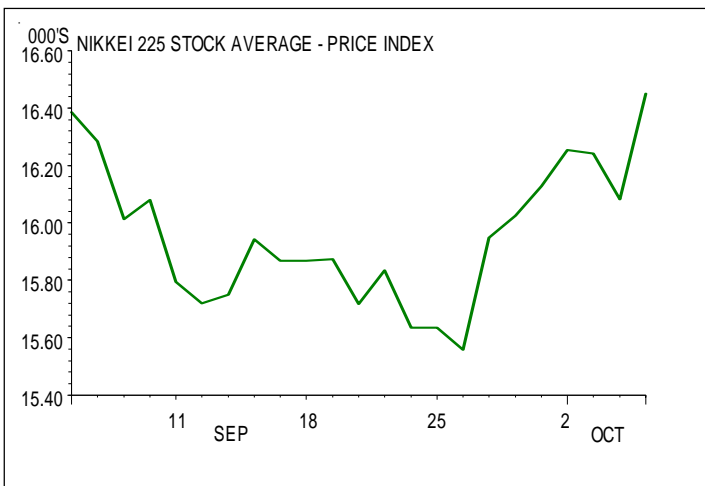
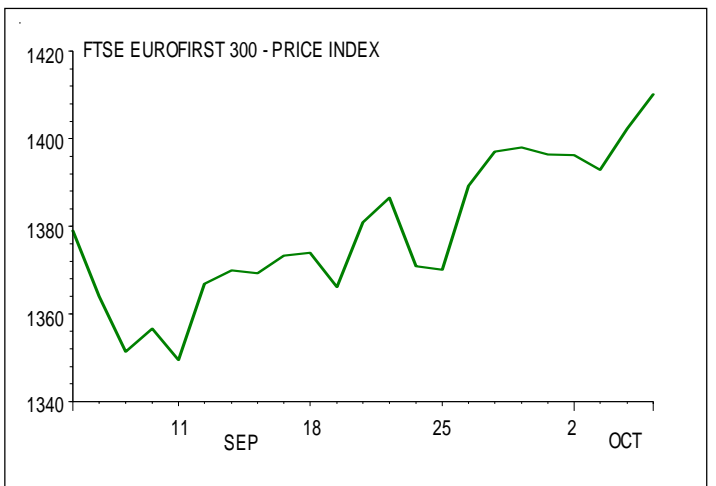


Chart 6: EU-12 equities scaled a 5-year high (1410.1)



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