



13 October 2006

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## Financial Markets Review

### Hawkish Fed boosts US dollar and global bond yields

*The dollar strengthened against major currencies, following hawkish Fed minutes and robust US data. Hopes for a near-term US rate cut have proved to be premature.*

*Global equity markets extend gains, with the Dow looking towards 12,000, though the Nikkei has underperformed in recent months.*

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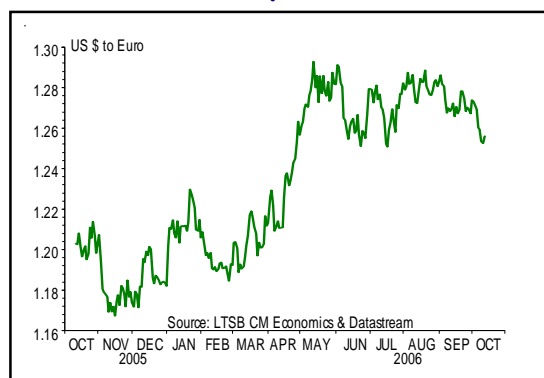
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#### Financial market review - foreign exchange

Financial markets have finally got the point that the US Fed does not think that the economy is ready for a cut in interest rates just yet. Perceptions are that economic growth was healthy in Q3. The euro fell 0.8% to 1.2495 against the dollar by end week and the pound also weakened by 0.8% to 1.4847. Against the Japanese yen, the dollar peaked at 119.83 on Wednesday, the highest rate since last December. Comments by Bank of Japan Governor Fukui, raising the prospect of another interest rate increase this year, helped the yen on Friday, but gains were short lived as strong US data was released.

The dollar drew support from hawkish comments from Fed members and from the minutes of September's FOMC meeting. The minutes suggested quite clearly that the Fed has no plans to cut rates and may even have to raise them if inflation does not slow. On Thursday, August's US trade deficit hit a new record of \$69.9bn, up from \$68bn in July, but this negative news was largely shrugged off. Nonetheless, given that the US is either at or close to the peak of its interest rate cycle, markets may react negatively should August's capital flows data, published next Tuesday, fail to provide adequate financing as was the case last month. Friday's publication of advance retail sales for September triggered initial dollar volatility, eventually taking the dollar to 1.2512 against the euro. Headline retail sales fell by 0.4% on the month, but sales excluding autos, gasoline and building materials, which is crucial in the assessment of consumer spending, rose 0.8% in September, twice as strong as August and the highest increase since last January. Later on Friday, the University of Michigan confidence survey soared to 92.3 in October from 85.4 in September, an early indication of healthy economic growth in Q4 and strengthened the dollar to within a whisker of 1.25 to the euro, before eventually edging below that level.

#### €/\$ tested 1.2500 on Friday



#### Financial market trends, ending Friday 13 Oct. '06

At 4.30pm 13 Oct. '06		Change from 6 Oct.'06 % change
FTSE 100	6157.6	+2.61%
<b>Exchange rates</b>		
US\$/UK £	1.8551	-0.83%
Euro €/UK£	1.4847	+0.01%
US\$/Euro €	1.2495	-0.84%
<b>Swaps - 5 year (mid rate)</b>		
UK pound	5.24	+9.0
US dollar	5.26	+12.0
Euro	3.94	+8.0
<b>Bond yields -10 year</b>		
UK	4.64	+8.0
US	4.80	+10.8
Euro	3.83	+7.8

UK data had little prolonged effect on sterling. On Monday, the currency was sold on the back of weak September producer price numbers. Producer input prices dropped 1.8% on the month, primarily due to lower prices of crude oil and fuels. Furthermore, core output prices rose by just 0.1% on the month, representing 2% on the year, and below August's 2.2%. Although this data showed that cost-push inflation may be becoming less of a risk as oil prices have declined, CPI inflation for the remainder of the year will be elevated by gas and electricity price rises and increases in university tuition fees. On Tuesday, August trade data was disappointing, but sterling losses were quickly recovered, despite concerns that net trade will not support UK economic growth in Q3.

There was little euro specific data published this week and the euro was mainly driven down by positive dollar sentiment. On Wednesday, eurozone Q2 GDP growth was confirmed at a quarterly rate of 0.9%. More important were the downward growth revisions by the European Commission for GDP growth in the next three quarters. Despite this, ECB President has reaffirmed the bias to raise rates in December in order to quell upside inflation risks from strong economic activity.

#### £/\$ also weaker, as dollar bulls gained upper hand



## Interest rate market review - bonds, cash and swaps

*Hawkish US FOMC minutes and central bank comments drive global bond yields higher, support by firm eurozone, US and UK data*

### Rolling calendar of UK data releases and events

M4 money supply (30/10)  
 Consumer credit (30/10)  
 Consumer conf (31/10)  
 PMI Manufacturing (1/11)  
 PMI Services (3/11)  
 Industrial production (6/11)  
 Manufacturing output (6/11)

### Rolling calendar of US data releases and events

FOMC decision (25/10)  
 Q3 GDP (27/10)  
 Personal income (30/10)  
 Personal spending (30/10)  
 PCE deflator (30/10)  
 Consumer conf (31/10)  
 Chicago PMI (31/10)

### 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 for the third week in the US, driven by hawkish comments from the Federal Reserve's Fisher on Tuesday and the FOMC minutes of the September 20th meeting on Wednesday. On Friday, the release of US retail sales showed a 0.4% fall in September, but yields actually rose as markets focused on the strong 0.8% rise in retail sales excluding autos and gas and also the strong increase in US consumer sentiment. The general fall in US bond prices helped yields to increase in the euro area and UK.

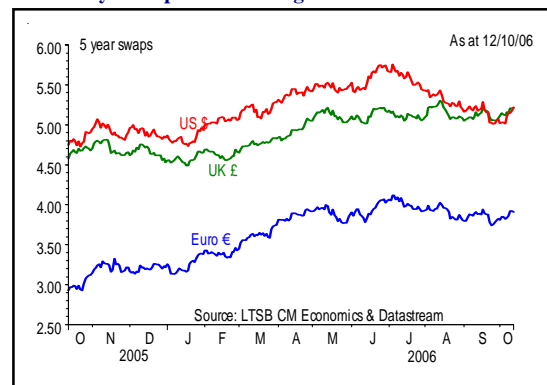
Local events also pushed European yields higher, helped by strong industrial production numbers from Germany and bullish UK British Chamber of Commerce (BCC) and British Retail Consortium (BRC) surveys, though weak UK producer input price data capped gains in gilt yields. ECB and BoE comments in the past week were also hawkish. The unexpected widening of the US August trade deficit to a record high, in spite of lower oil prices, had limited impact on the markets, as did the wider UK August trade deficit.

Comments from Fed member Fisher on Tuesday were hawkish and suggested that forecasts of near-term US interest rate cuts, though never our view, were off the mark. Fisher noted that, while the housing market has slowed, the rest of the economy is "running on all pistons". He also said that the "current rate of inflation is too high". His comments prepared the ground for the FOMC minutes on Wednesday, which were more hawkish than expected. The minutes reiterated concerns about current inflation.

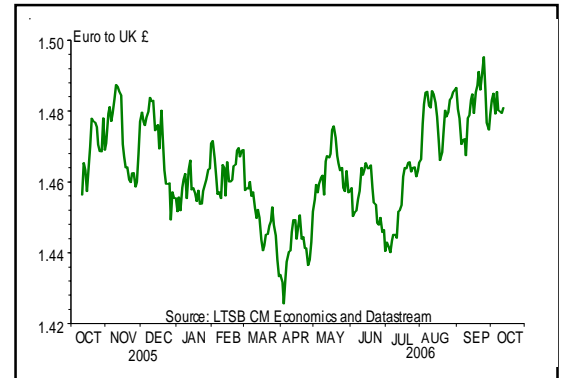
Overall, the Fed looks likely to keep interest rates on hold at 5.25% in the near term and the risk of a further hike cannot be entirely ruled out, particularly if the recent fall in oil prices supports economic growth and therefore increases the risk that core inflation remains elevated. Over the week, US 2-year bond yields rose 13bps to 4.86% and 10-year yields increased 11bps to 4.80%, while 5-year swaps rose 12bps to 5.26%.

UK bond yields also rose in the past week, though to a lesser degree than in the US. Producer input prices fell more than expected in September by 1.8% and factory gate prices were also weaker than anticipated. Further,

### Global 5yr swaps extended gains this week



### £/€ little changed this week, with focus on US dollar

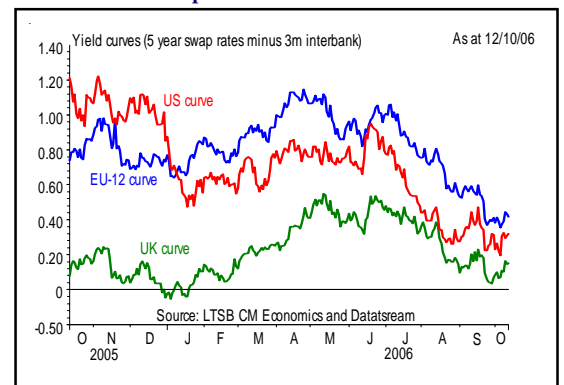


the positive BRC and BCC surveys and hawkish BoE comments from new MPC members, Besley and Sentance, largely reaffirm our view that interest rates will rise to 5% at the next MPC meeting in November. The RICS house price survey was also strong, suggesting that housing market activity will remain strong in the coming months. In detail, the BRC survey showed a rise in the total value of retail sales in September by a firm 5.2% on the year. The Q3 BCC survey pointed to stronger exports, employment and investment, while the RICS house price survey rose to a 4-year high. The week therefore saw UK 2-year yields rise to 5.03% from 4.97%, the highest for more than 2 years, and 10-year yields increase to 4.64% from 4.56% a week earlier, while 5-year swaps rose 9bps to 5.24%.

Eurozone bund yields also rose in the past week, driven by developments in the US markets and also by a sharp 1.9% monthly rise in German industrial output, with France and Italy also reporting strong rises. ECB President Trichet's testimony to the EU Parliament reaffirmed that interest rates are likely to rise to 3.5% by the end of the year. But the increase in yields were capped by a downward revision to the EU Commission's eurozone quarterly growth forecasts (Q1 2007 now seen in the 0.0-0.5% range) and strong demand for the September 2008 Schatz issue, which was covered 2.5 times. Demand for the US TIPS and UK index-linked bond auctions in the past week were also strong. Eurozone 2-year yields rose 8bps on the week to 3.68%, 10-year yields also rose 8bps to 3.83% and 5-year swaps increased to 3.94% from 3.86%.

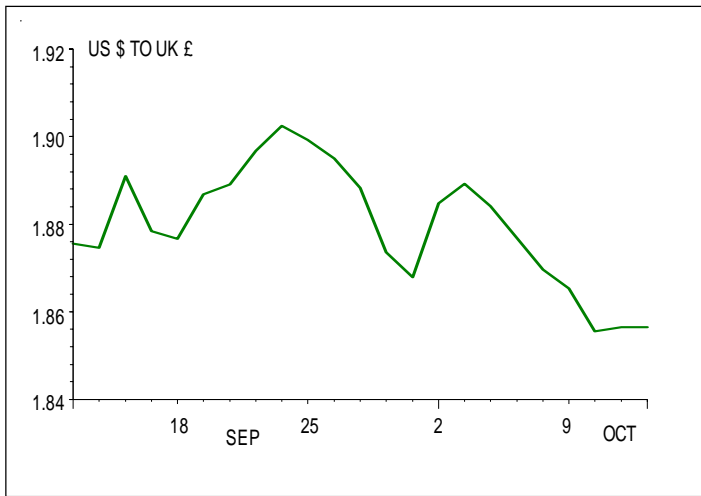
**Nichola James, Senior Economist**  
**Hann-Ju Ho, Senior Economist**

### Yield curves steepened this week

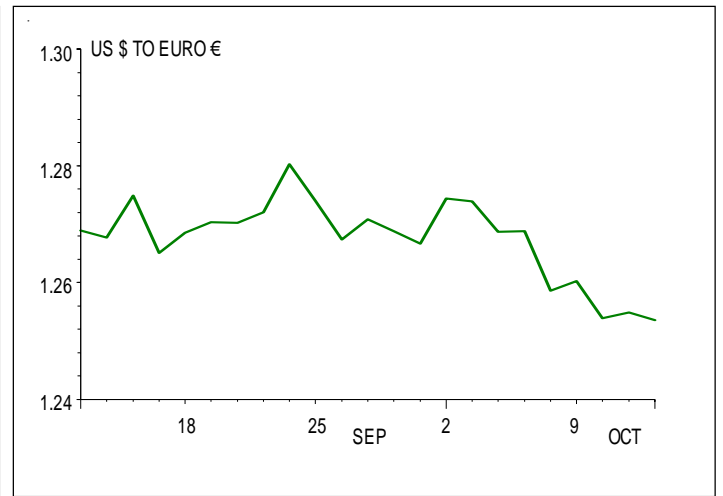


# FOREIGN EXCHANGE - GRAPHICAL ANALYSIS OF RECENT TRENDS

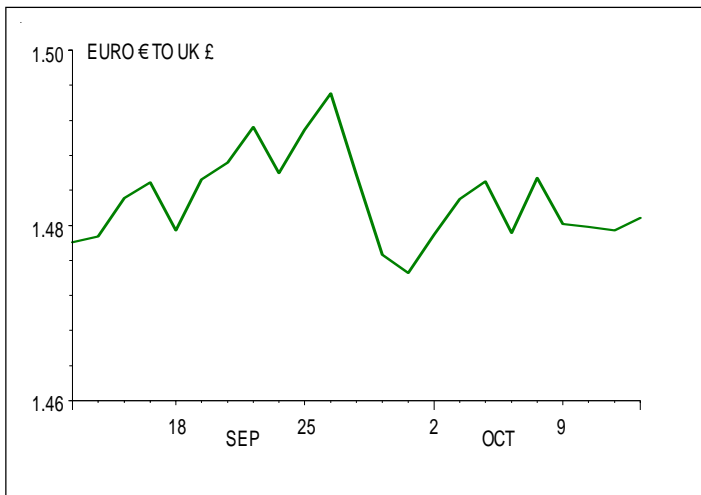
**Chart 1: £/\$ fell below 1.8600**



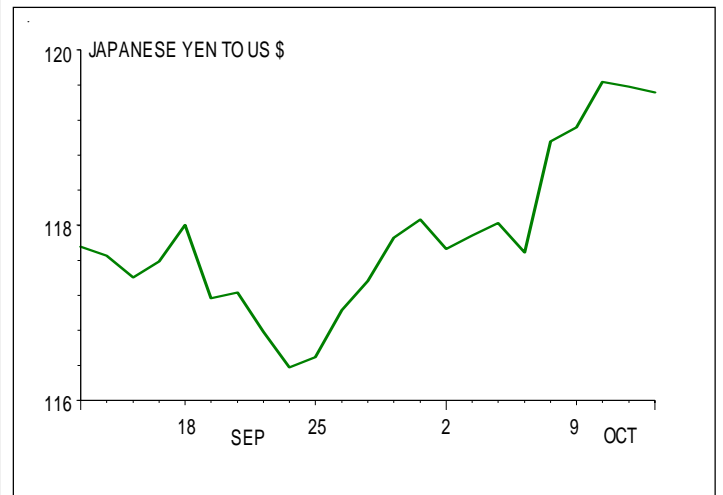
**Chart 2: €/€ tested 1.2500 on Friday, after bullish US data**



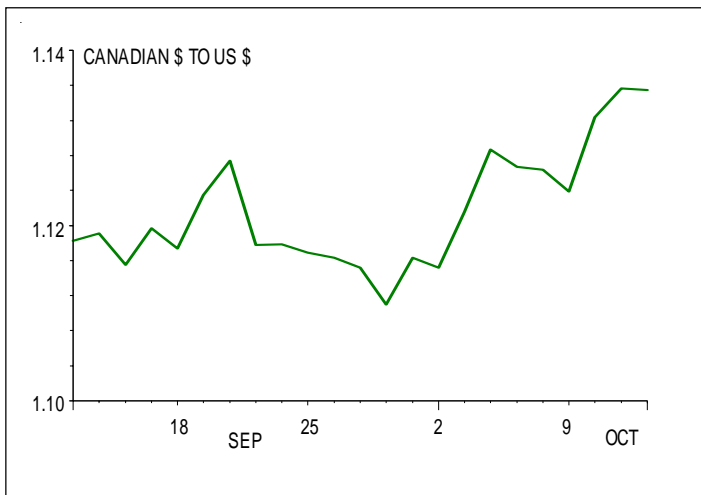
**Chart 3: £/€ broadly range-bound**



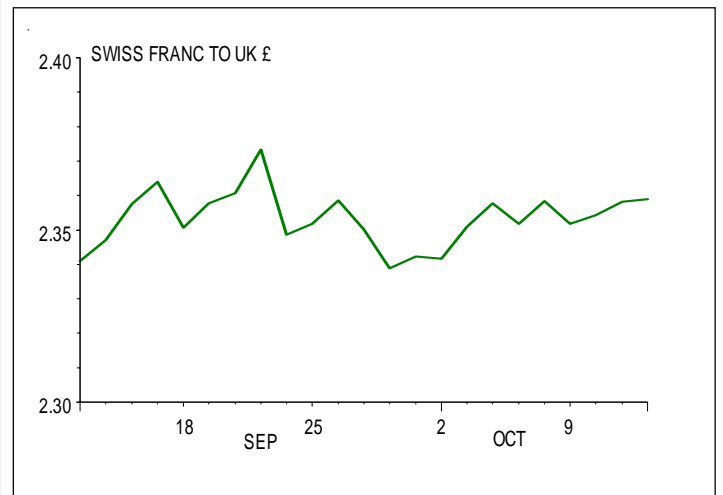
**Chart 4: \$/¥ was around 10-month highs**



**Chart 5: \$/Cad headed towards 1.1400, last reached July 25th**

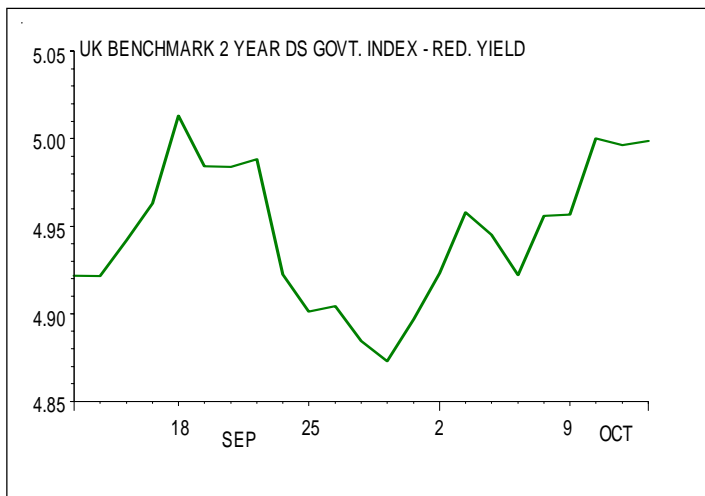


**Chart 6: Swissie broke above 2.36 on Friday**

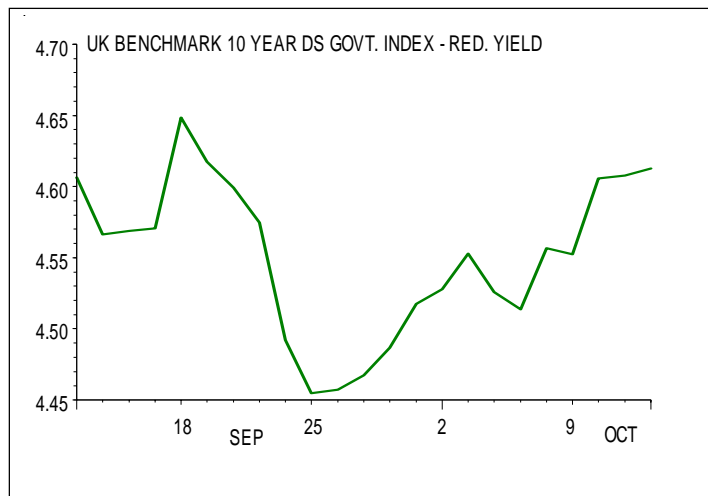


# FIXED INCOME - GRAPHICAL ANALYSIS OF RECENT TRENDS

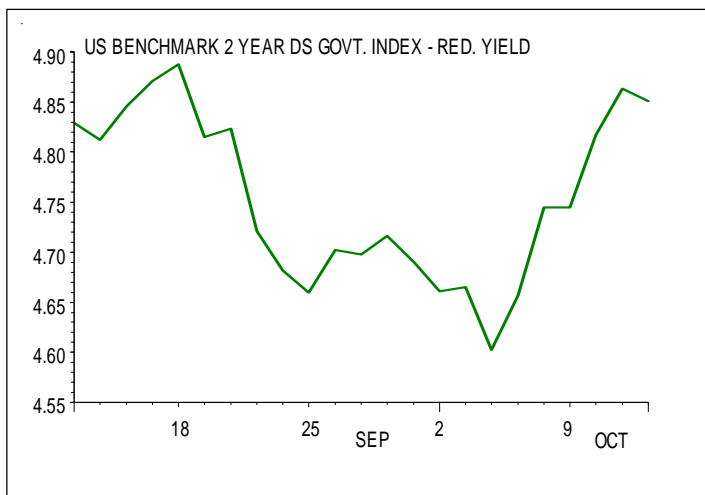
**Chart 1: UK 2yr yields highest for more than 2 years on Friday**



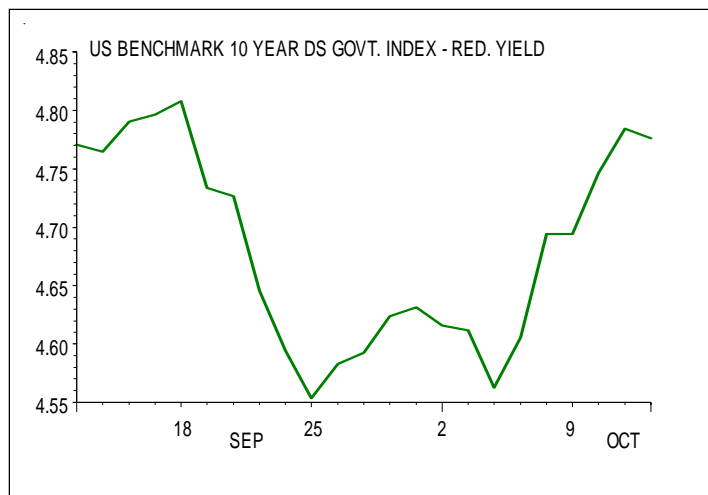
**Chart 2: UK 10yr yields tracked US markets higher**



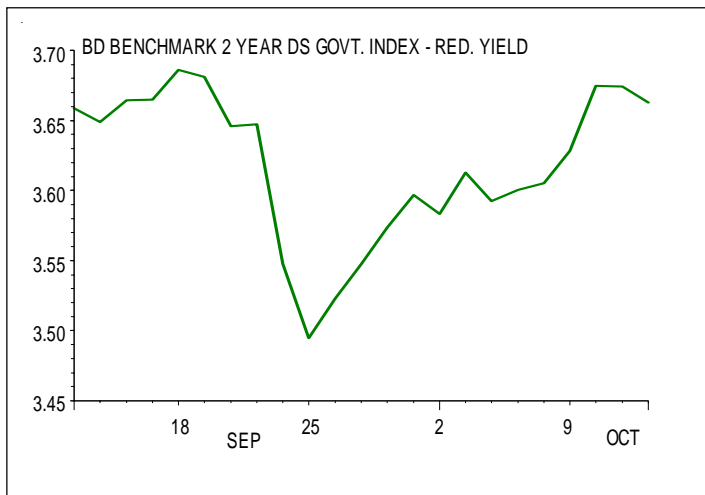
**Chart 3: US 2yr yields rose as near-term rate cut hopes fade**



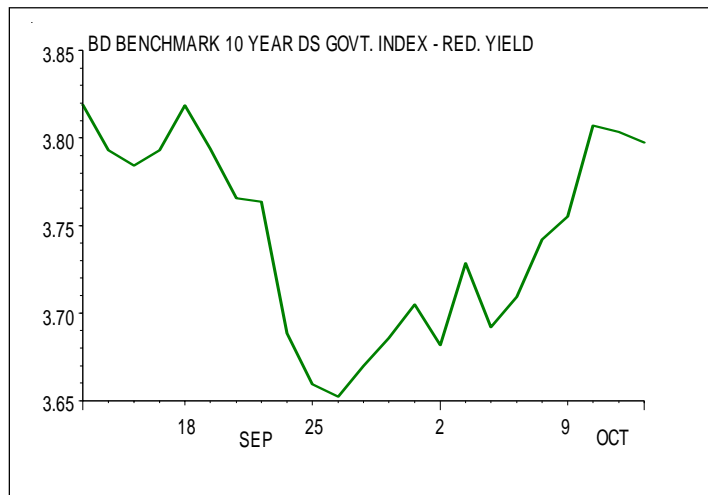
**Chart 4: US 10yr yields rose for third straight week**



**Chart 5: EU-12 2yr yields were up 8bps on the week**



**Chart 6: EU-10yr yields increased to above 3.8%**



# INTEREST RATE MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

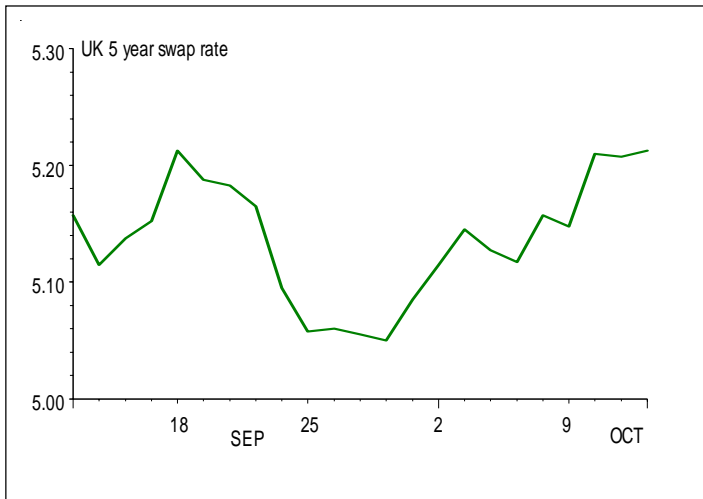
**Chart 1: US 5yr swaps rose 12bps to 5.26%**



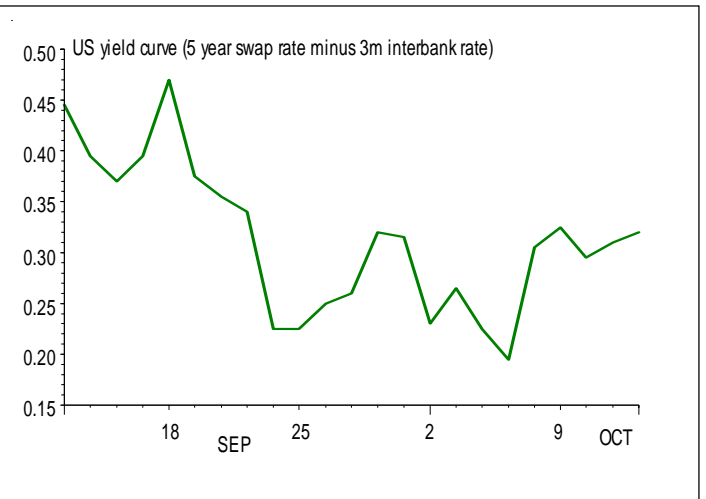
**Chart 2: EU-12 5yr swaps rose 8bps to 3.94%**



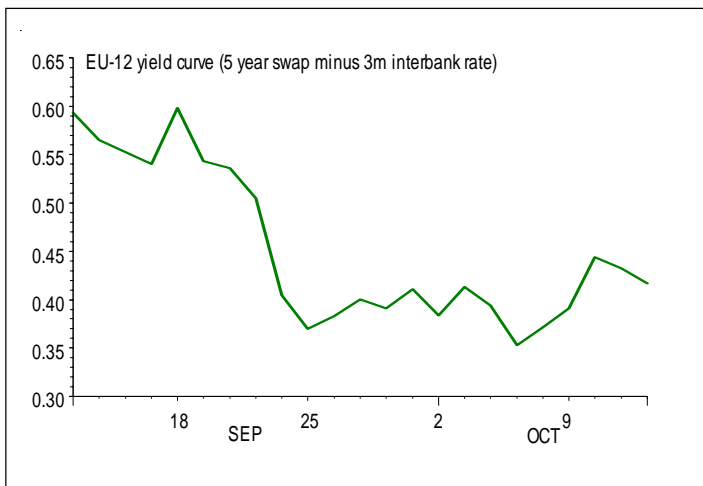
**Chart 3: UK 5yr swaps rose to 2-month high**



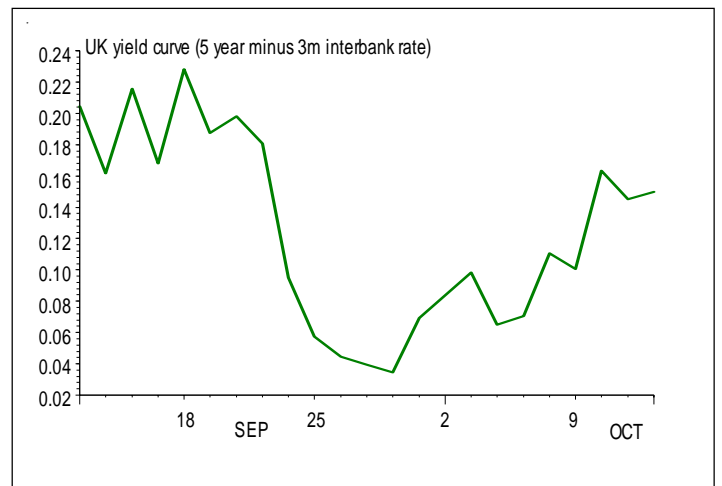
**Chart 4: US yield curve steepened this week**



**Chart 5: Eurozone yield curve steepened in line with the US**

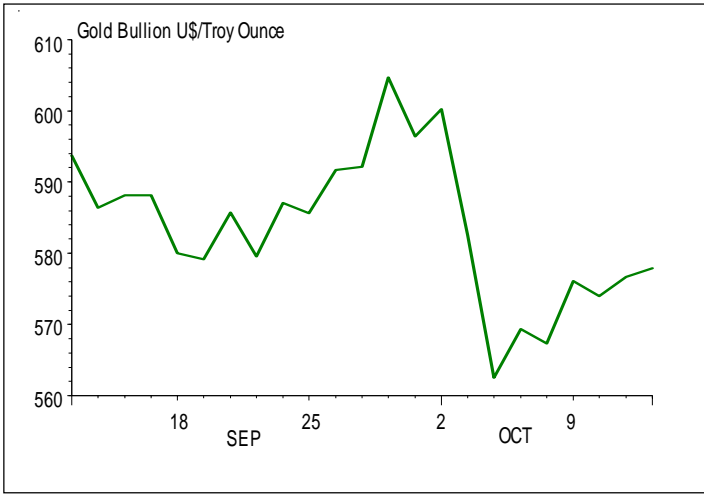


**Chart 6: UK yield curve also steeper this week**

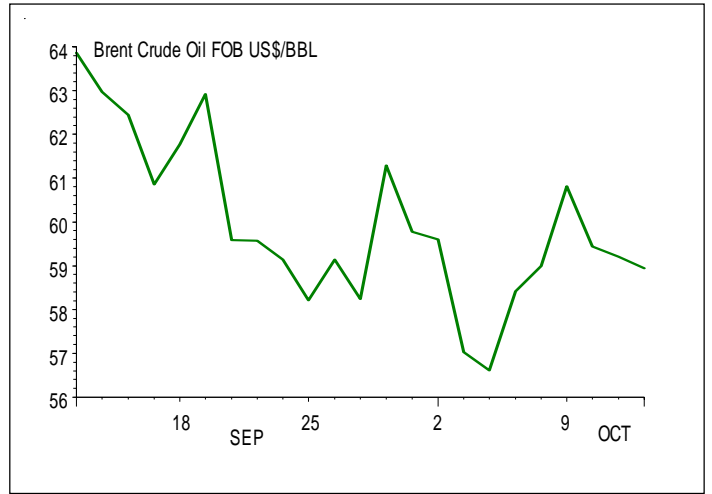


# KEY COMMODITY & EQUITY MARKETS - GRAPHICAL ANALYSIS RECENT TRENDS

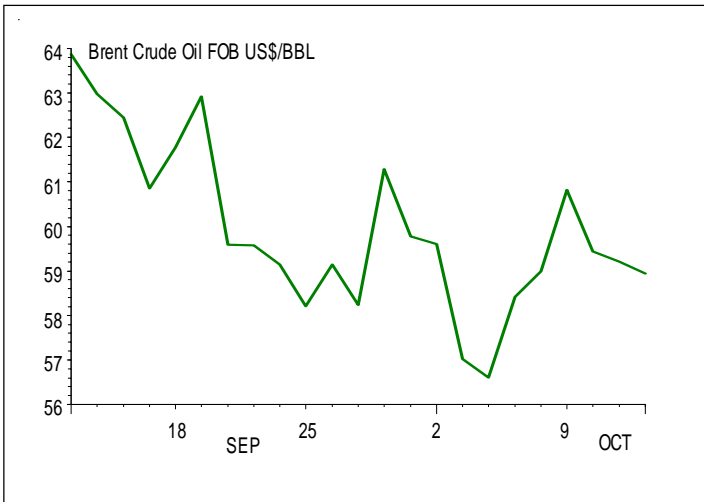
**Chart 1: Gold prices edged higher this week**



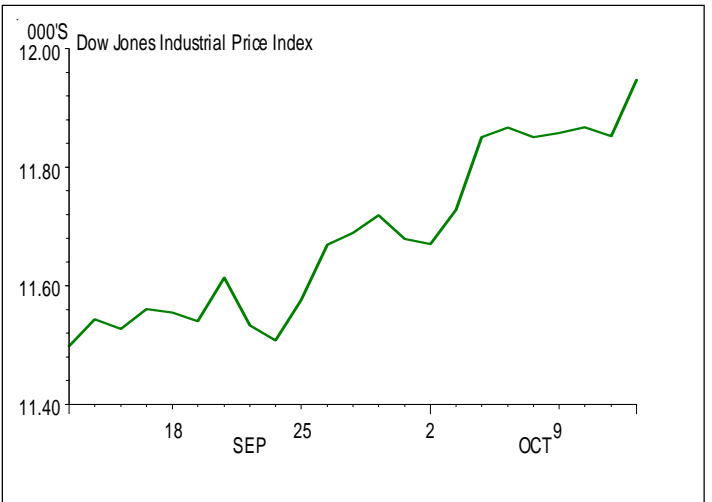
**Chart 2: Oil prices little changed this week, but trend is lower**



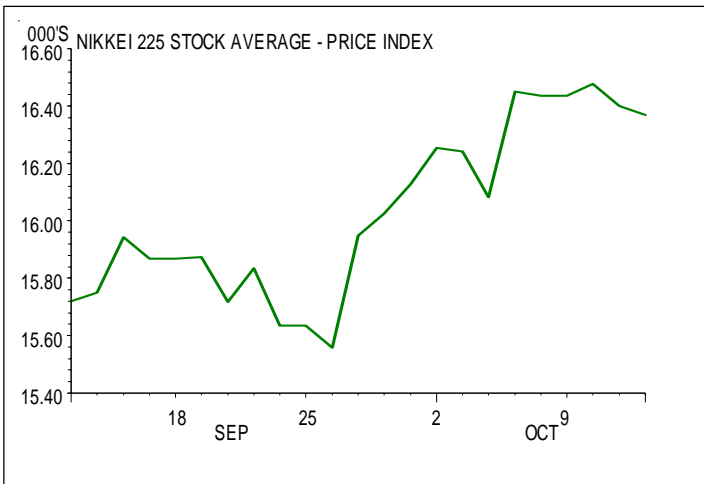
**Chart 3: The FTSE 100 increased to highest level this year**



**Chart 4: The Dow has 12,000 in sight**



**Chart 5: Nikkei-225 underperforming other main equity indices**



**Chart 6: EU-12 equities up more than 2% this week**

