



20 October 2006

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## Financial Markets Review

### Sterling outperforms, supported by data and minutes

*Sterling was supported by MPC minutes and strong inflation and growth data last week. The US dollar ends a three-week rise against major currencies, despite a surprise rebound in housing starts and strong capital flows data.*

*The euro shrugs off Italy's credit rating downgrade, but loses ground to the pound.*

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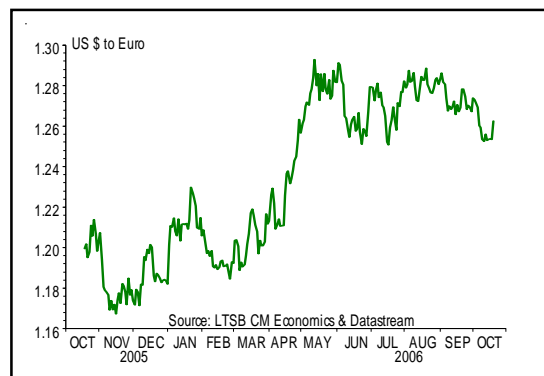
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#### Financial market review - foreign exchange

The dollar pared back some of last week's gains as the pound and the euro both appreciated to 1.8812 and 1.4921, respectively. With the October MPC minutes and economic data releases strongly vindicating a 25bp increase in UK interest rates in November, sterling appreciated against the euro to 1.4921. Following the announcement of Russia's foreign exchange reserve diversification into yen, the currency appreciated against the dollar to 118.65.

UK economic data releases were mainly sterling supportive in the week. On Tuesday, although headline CPI weakened, the sharp rise in the RPI inflation measure, which includes mortgage interest payments, to 3.6% in September from 3.4% in August, representing an 8-year high. The worrying aspect of this is that RPI is the inflation measure normally used as a benchmark for wage agreements and its further acceleration to as high as 4.5% early next year suggests significant upside risks to wage growth. Signs of underlying inflationary pressure were also prevalent in rising core CPI, which excludes energy and food, from 1.1% in August, to 1.4% in September. On Wednesday, financial markets marked up sterling following the publication of the minutes of the October MPC meeting, which showed a vote of 7:2 to keep rates on hold, with the two new members, Andrew Sentance and Timothy Besley, voting for an immediate hike. On Thursday, September's UK retail sales came in weaker than expected, falling 0.4% on the month. However, the implied retail sales deflator rose to 0.6% in September from 0.1% in August, signalling that the retail sector has more pricing power. Also released on Thursday was M4 money supply growth, which accelerated to 14.5% in September from 13.7% in August. Although we know the MPC to be concerned about strong monetary growth, sterling weakened following the retail sales release. Friday's Q3 GDP outcome was stronger than the markets expected showing the continuation of quarterly

#### €/\$ ended three-week run of decline



#### Financial market trends, ending Friday 20 Oct. '06

At 4.00pm 20 Oct. '06		Change from 13 Oct.'06 % change
<b>FTSE 100</b>	<b>6142.7</b>	<b>-0.24%</b>
<b>Exchange rates</b>		
<b>US\$/UK £</b>	<b>1.8812</b>	<b>+1.37%</b>
<b>Euro €/UK£</b>	<b>1.4921</b>	<b>+0.60%</b>
<b>US\$/Euro €</b>	<b>1.2609</b>	<b>+0.77%</b>
<b>Swaps - 5 year (mid rate)</b>		
<b>UK pound</b>	<b>5.28</b>	<b>+3.0</b>
<b>US dollar</b>	<b>5.24</b>	<b>-2.0</b>
<b>Euro</b>	<b>3.95</b>	<b>+1.0</b>
<b>Bond yields -10 year</b>		
<b>UK</b>	<b>4.69</b>	<b>+4.0</b>
<b>US</b>	<b>4.78</b>	<b>-2.0</b>
<b>Euro</b>	<b>3.84</b>	<b>+1.0</b>

growth at 0.7%, 2.8% on the year, leading to sterling breaking through \$1.88.

US data was mixed this week. On Tuesday, capital inflow data showed a strong rebound from just \$32.9bn in July to \$116.9bn in August, a new record. It comfortably covered the \$69.9bn trade deficit in August, easing short term funding concerns. However, the dollar was sold following the publication of a 0.6% decline in industrial output shortly afterwards. On Wednesday, data was supportive of a hike in interest rates - core CPI inflation rose to 2.9% in September from 2.8% in August and housing starts jumped 5.9% in September to 1.77m.

The euro shrugged off concern that Italy would drop out of euro membership due to a credit ratings downgrade. In terms of economic data, the divergence between the optimistic current and pessimistic future ZEW index of German investor sentiment continued in October. In addition, although the final euro annual CPI inflation figure for September was revised down to 1.7% from the earlier estimate of 1.8%, this does not alter our outlook for higher euro zone interest rates in December as Trichet has warned that inflation will rebound back above the 2% target in coming months.

#### £/\$ rose on hawkish minutes and strong data



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

UK bond yields rose, as markets priced in further rate hikes in 2007, with inflation and growth surprising on the upside. ECB to be more data dependent in 2007.

### 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 prod. (6/11)  
Manufacturing output (6/11)

### Rolling calendar of US data releases and events

Personal income (30/10)  
Personal spending (30/10)  
PCE deflator (30/10)  
Consumer conf (31/10)  
Chicago PMI (31/10)  
ISM Manu. (1/11)  
Q3 Productivity (2/11)

### 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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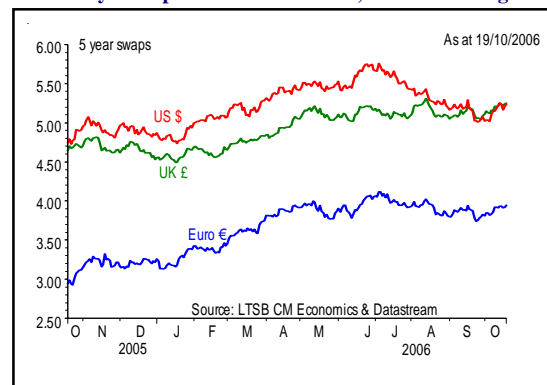
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Short-dated UK bond yields this week increased to the highest level for more than two years, with 2-year yields increasing to 5.06%. A quarter-point rate rise by the BoE in November from the current 4.75% level is virtually a done deal and markets were increasingly pricing in further policy tightening next year. The minutes of the October MPC meeting showed a 7-2 vote for no change in interest rates, compared with expectations of a unanimous vote. The Committee's newest members, Sentance and Besley, voted for an immediate rate rise, citing resilient consumption, a robust investment outlook, a risk of higher inflation expectations and strong money supply growth. The majority of MPC members sympathised with the view that rates will rise, but preferred to wait until the November meeting when the next Inflation Report is released.

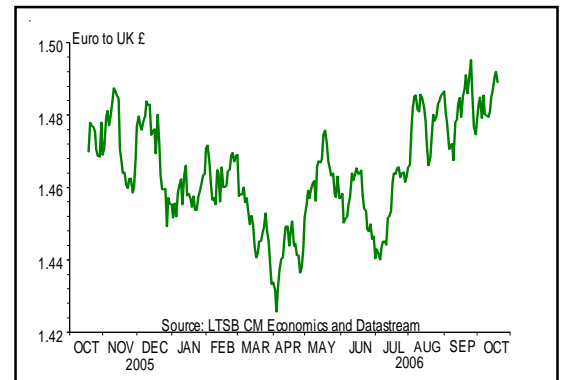
Therefore, the debate centred on whether the MPC would raise rates above 5% next year. We believe that the economic fundamentals justify a rise to 5.25% in early 2007. Although the data this week showed a fall in annual CPI to 2.4% in September from 2.5%, the core rate jumped to 1.4% from 1.1% and the RPI measure, which is still the usual benchmark for wage negotiations, increased to an 8-year high of 3.6%. Bond yields had come under some pressure from a renewed rise in claimant count unemployment, which rose 10,200 in September, and an unexpected 0.4% fall in September retail sales. However, on Friday, it was revealed that the economy grew by a robust 0.7% in Q3, above market expectations of 0.6% and in spite of softer retail sales growth during the quarter. UK 5-year swaps rose to 5.28% from 5.25% a week earlier and 5.19% a month ago. Similarly, 2-year yields increased to 5.06% from 5.04% a week ago and 5.00% a month ago.

The situation for eurozone interest rates is not dissimilar to the UK. ECB speakers this week hinted again that interest rates are expected to rise by a further quarter point to 3.5% by the end of the year. As with the BoE, the big question was what will happen to rates in 2007. ECB Council members officially remained undecided and tight-lipped about this. However, "senior sources" in the ECB reportedly said that

### Global 5yr swaps mixed this week, but trend higher



### £/€ back above 1.49 this week

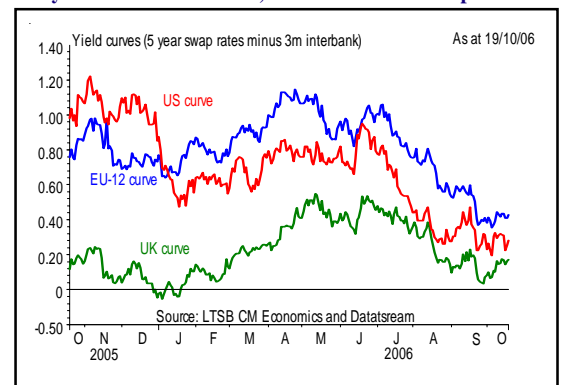


interest rates could rise to 4% or above, if solid growth and a rebound in oil prices to \$70 fuelled inflation pressures. On the other hand, these sources also suggested that weaker-than-expected eurozone growth next year, caused perhaps by the German VAT rise or a US slowdown, could lead to a pause in policy tightening. Hence, the ECB is set to become more data dependent from next year, similar to the Fed's current policy stance. Data releases during the week weighed slightly on eurozone yields. EU-12 September CPI was revised down to 1.7% from 1.8%, while the headline German ZEW survey fell for a ninth month to -27.4. However, CPI inflation is expected to track higher in the coming months and the current situation component of the ZEW continued to improve. Further, Italy's credit ratings downgrade pushed yields higher. Overall, German 2-year yields rose 2bps on the week to 3.70% and 5-year swaps also rose 1bp to 3.95%.

The US data flow this week removed any lingering market hopes of near-term interest rate cuts. Annual core CPI rose to 2.9% in September, well above the Fed's 2% comfort level, while housing starts jumped 5.9% in September to 1.77m. Core producer prices were also stronger than expected, rising 0.6% on the month. However, industrial production and the Philly Fed business survey were weaker than expected. Over the week, US 2-year yields were unchanged at 4.86% and 5-year swaps fell 2bps to 5.24%, while 10-year yields fell 2bps to 4.78%.

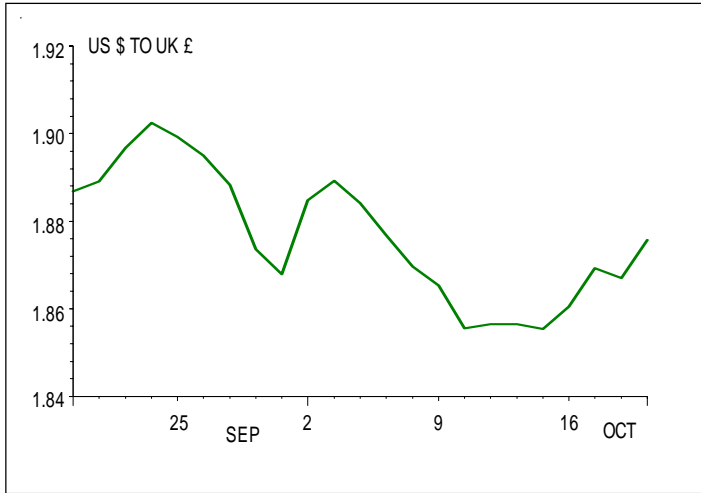
### Nichola James, Senior Economist Hann-Ju Ho, Senior Economist

### US yield curve flattened, as Fed rate cut hopes fade

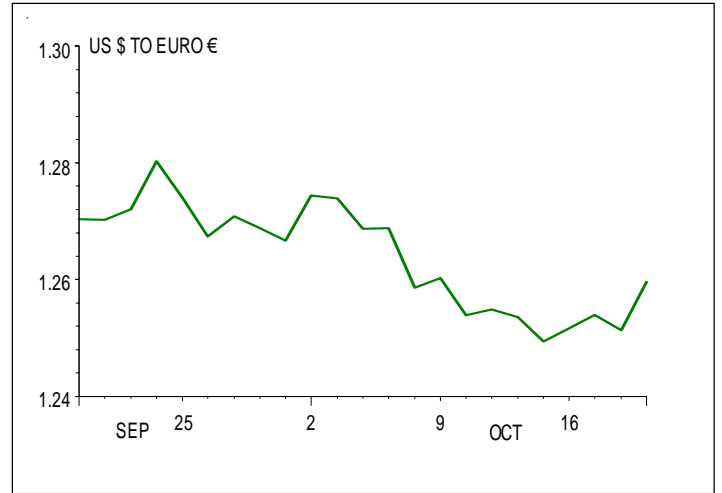


# FOREIGN EXCHANGE - GRAPHICAL ANALYSIS OF RECENT TRENDS

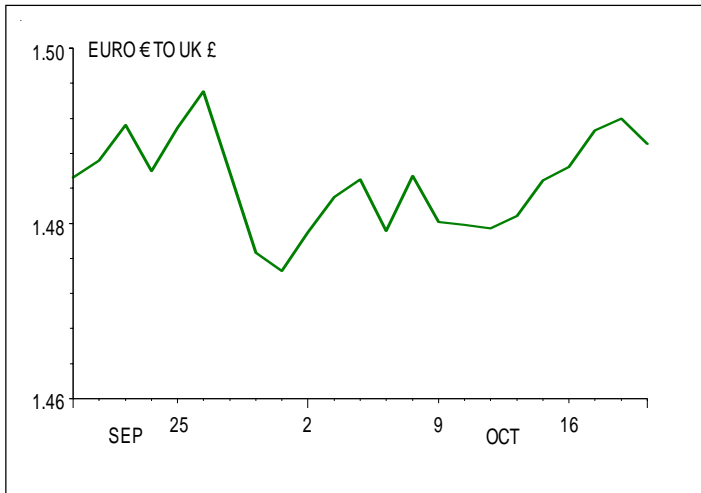
**Chart 1: £/\$ broke back above 1.88**



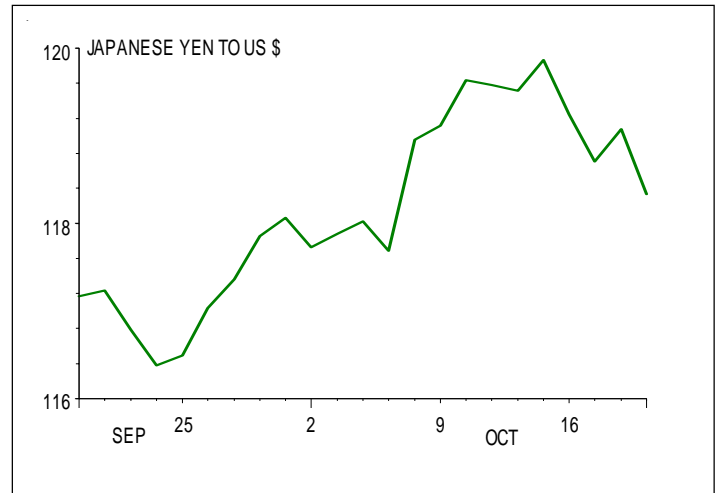
**Chart 2: €/\$ rose for the time in four weeks**



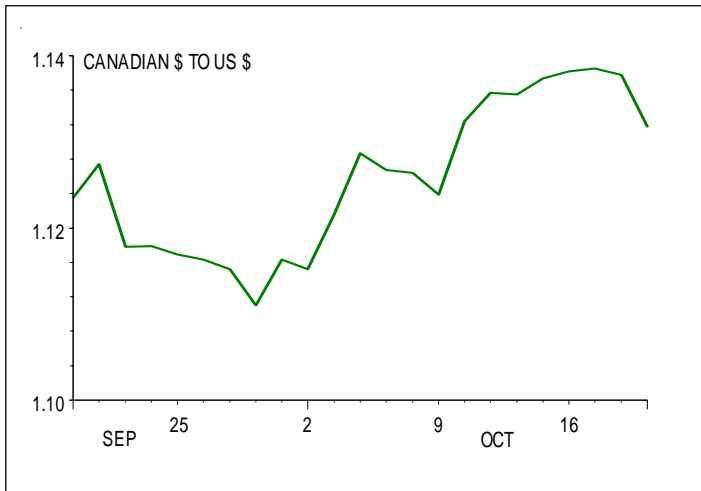
**Chart 3: £/€ testing recent high of 1.4928**



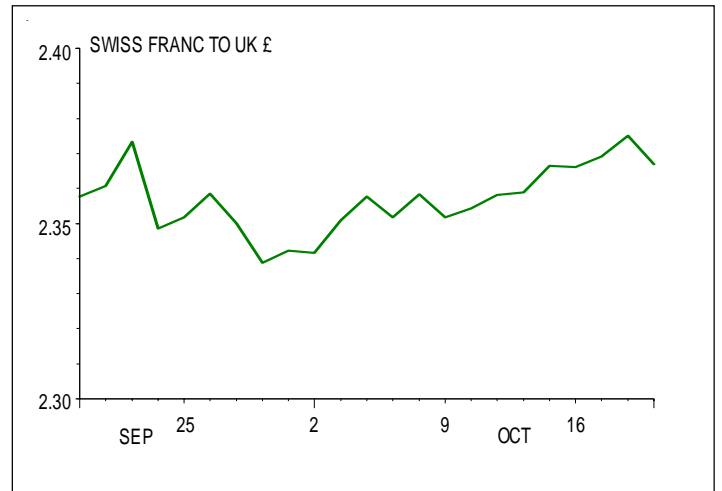
**Chart 4: \$/¥ fell as Russian central bank raised yen reserves**



**Chart 5: \$/Cad fell from 3-month highs**

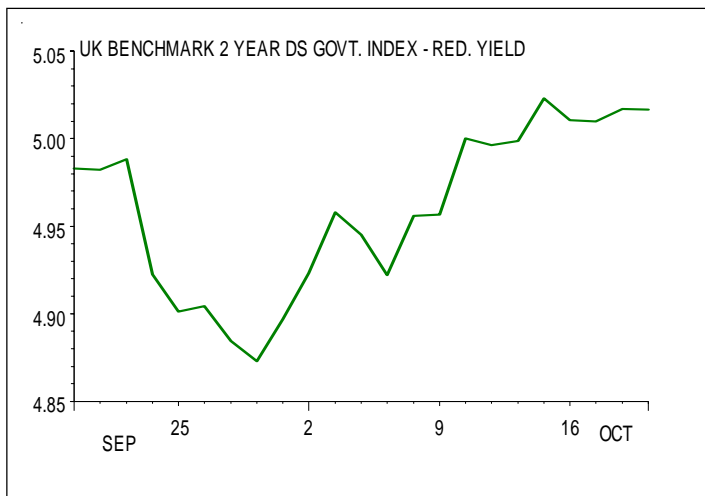


**Chart 6: Swissie rose to 4-year highs**

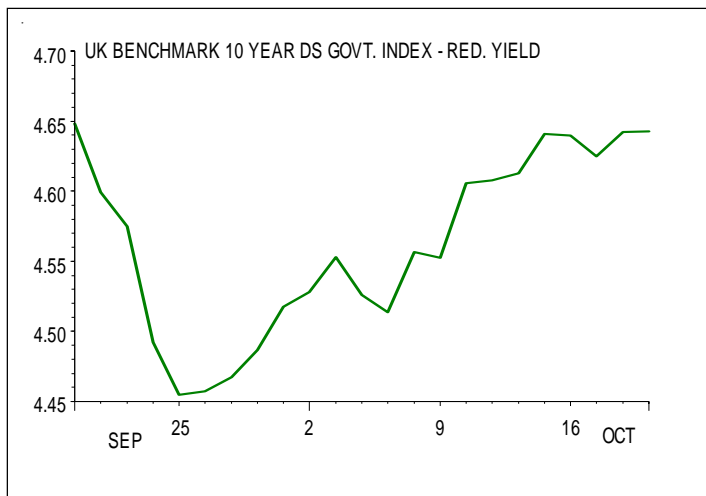


# FIXED INCOME - GRAPHICAL ANALYSIS OF RECENT TRENDS

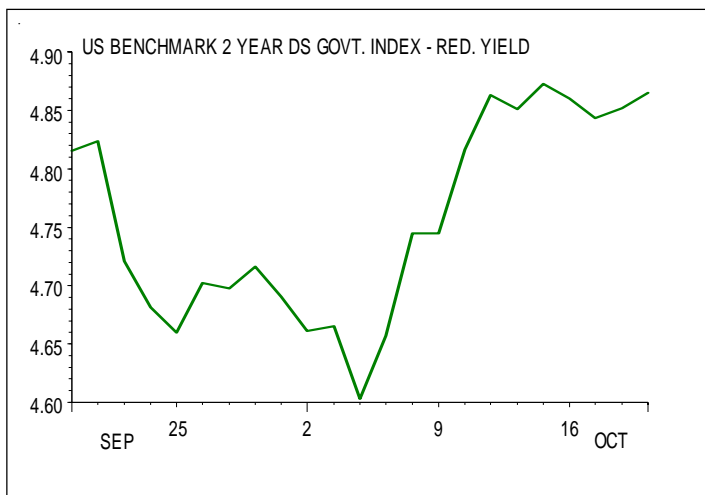
**Chart 1: UK 2yr yields highest for more than two years**



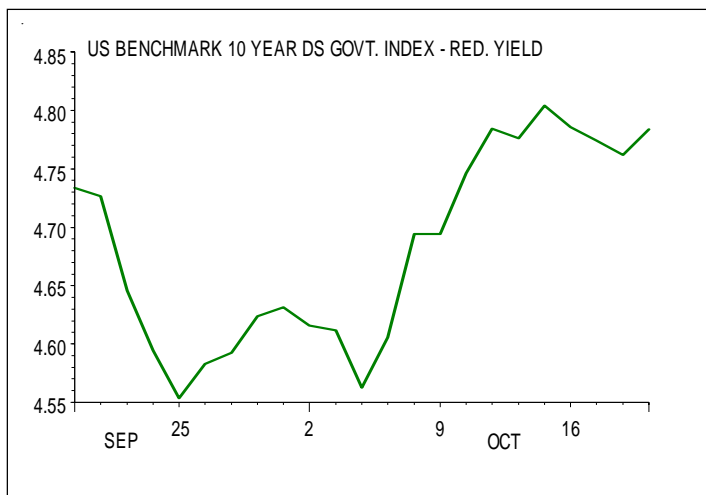
**Chart 2: UK 10yr yields rose to 2-month highs**



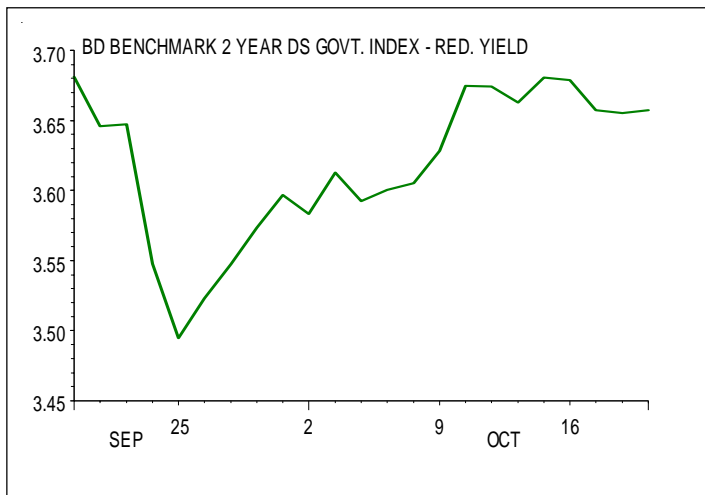
**Chart 3: US 2yr yields little changed on the week**



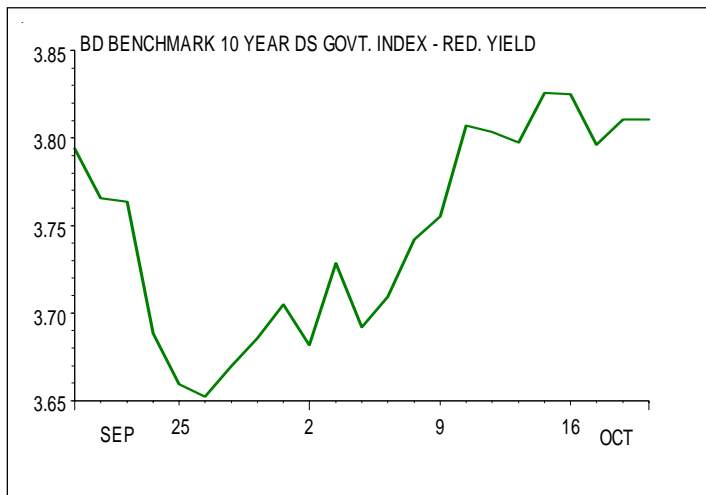
**Chart 4: US 10yr yields slightly lower, after recent rises**



**Chart 5: EU-12 2yr yields increased to 3.70% on Friday**

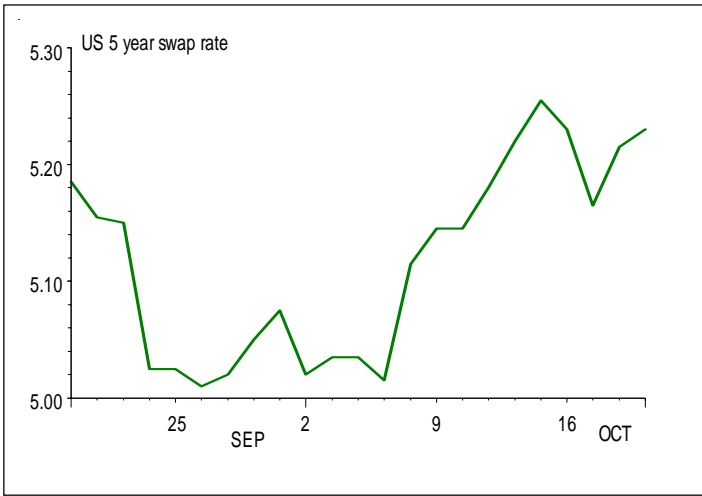


**Chart 6: EU-10yr yields up from 3.66% on Sep 26th**



# INTEREST RATE MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

**Chart 1: US 5yr swaps fell 2bps to 5.24%**



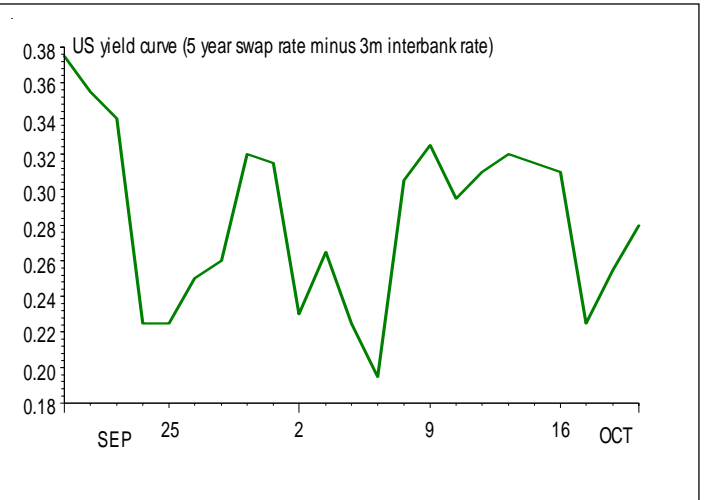
**Chart 2: EU-12 5yr swaps increased to 2-month highs**



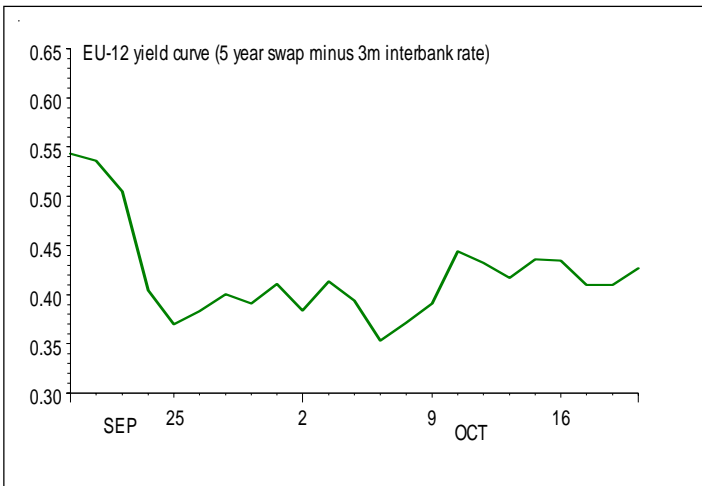
**Chart 3: UK 5yr swaps have risen 17bps in the last four weeks**



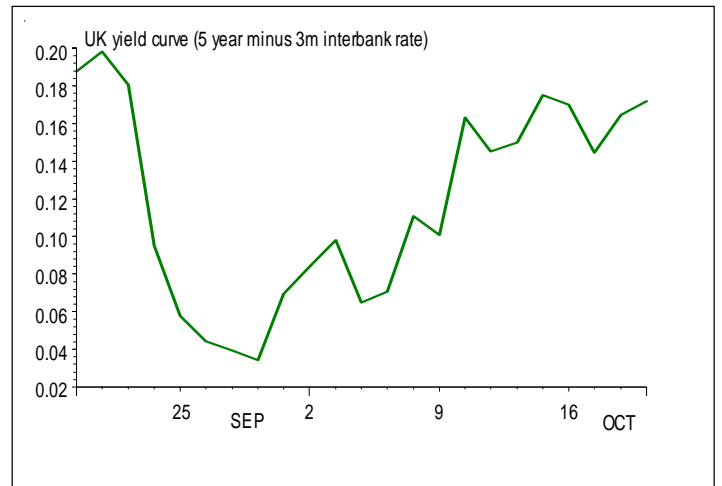
**Chart 4: US yield curve flattened, as rate cut hopes faded**



**Chart 5: Eurozone yield curve flattened, as 3m rates rose 3bps**

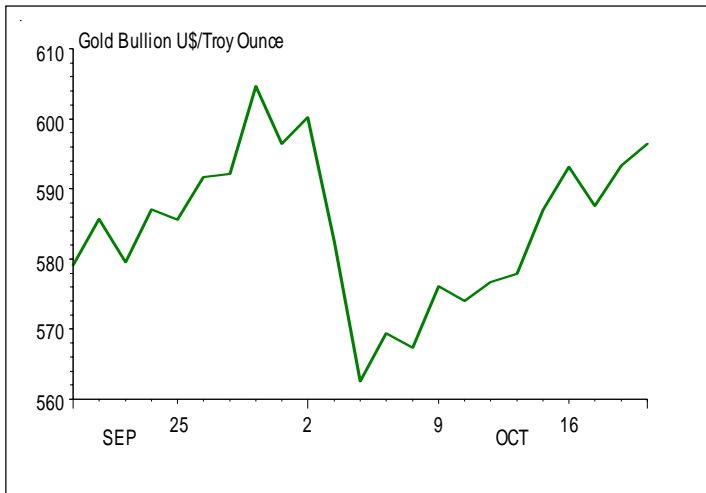


**Chart 6: UK yield curve steady, but steepening trend**

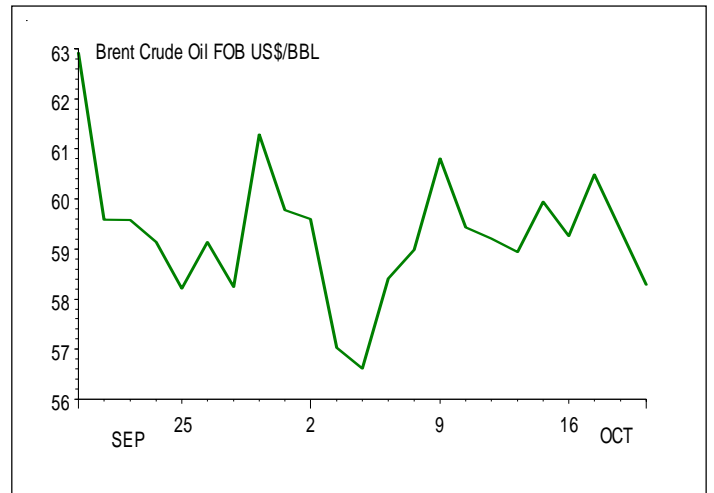


# KEY COMMODITY & EQUITY MARKETS - GRAPHICAL ANALYSIS RECENT TRENDS

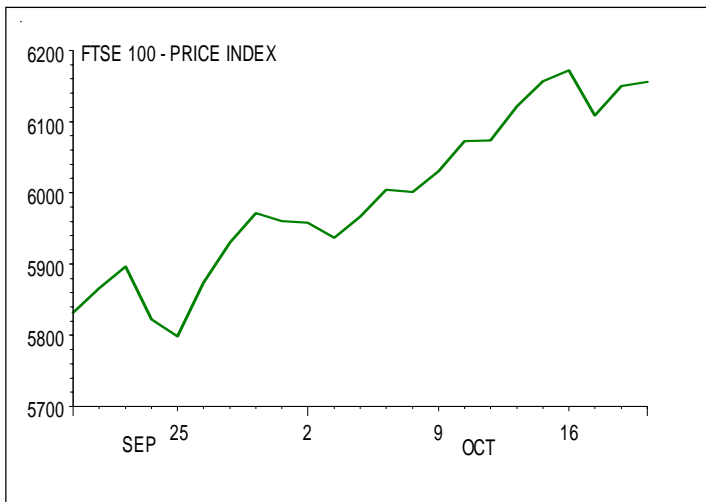
**Chart 1: Gold prices edged higher this week**



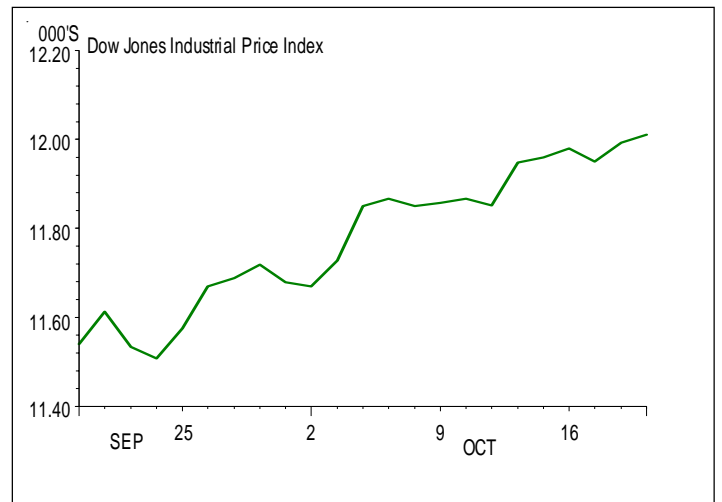
**Chart 2: Oil prices broadly unchanged at around \$60 a barrel**



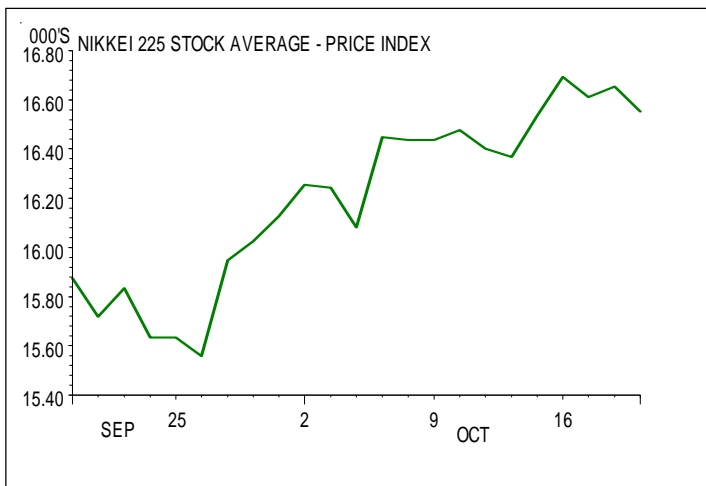
**Chart 3: The FTSE 100 steady, after gains in previous 3 weeks**



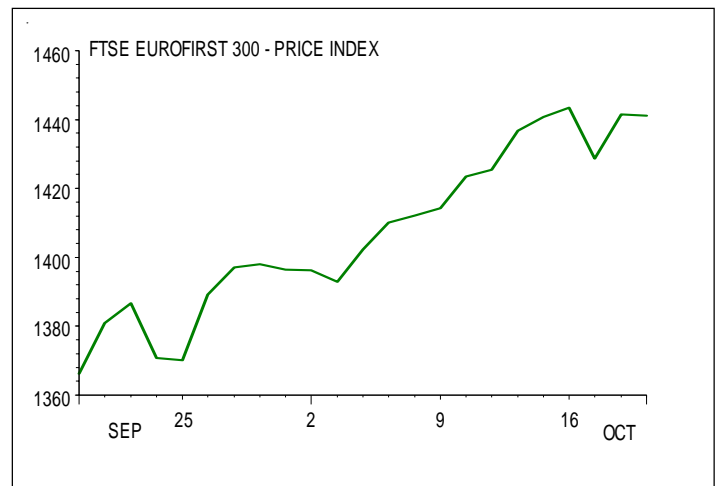
**Chart 4: The Dow remained solid**



**Chart 5: Nikkei-225 at highest level since May**



**Chart 6: EU-12 equities highest since dotcom boom**



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