



27 October 2006

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Financial Markets Review

Disappointing US Q3 gdp growth weighs on dollar

The dollar closed lower against its main trading partners for a second consecutive week following reports on Friday that US gdp growth slowed to just 1.6% in Q3 - the weakest since Q1 2003

Equities remained in favour this week, with the Dow hitting a new record high and the FTSE 100 closing above 6,200 for the first time since February 2002

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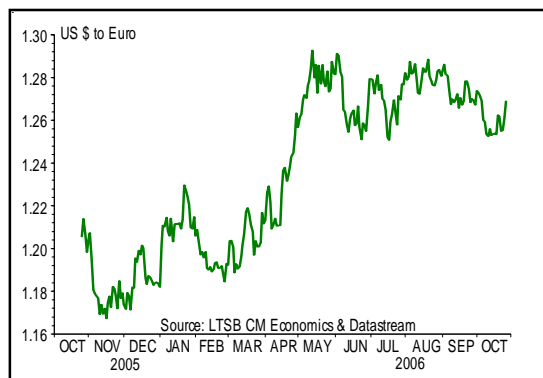
Financial market review - foreign exchange

Financial market attention was primarily focused on the US this week. As widely expected, the Federal Reserve left interest rates at 5.25% on Wednesday for a third successive FOMC meeting. The accompanying statement to the decision was largely unchanged, despite fears of a more hawkish tone, however it still kept open the possibility of further rate rises in the future. Mr Lacker again dissented with the majority and voted for a rate rise for the third consecutive meeting. The first estimate of US Q3 gdp on Friday showed annualised gdp growth slowed to just 1.6% and helped to ensure the dollar closed down for a second consecutive week against its main trading partners. €/\$ ended the week 0.8% up at 1.2720 and £/\$ added 0.9% to 1.8968. \$/¥ closed at 117.57 after rallying to 119.66 in the week. The euro was also buoyed by firm economic data and this helped £/€ to close the week 0.1% lower at 1.4909. Commodity currencies fared well, with the AUD hitting a 7-week high against the US\$ on rising expectations of an increase in Australian interest rates next month.

UK economic data were thin on the ground and had only a limited market impact this week. The CBI Industrial Trends survey headline new orders index fell to a 9-month low on Tuesday, at -20 in October from -5 in September. The outturn was much weaker than expected as domestic and overseas orders both declined. We remain of the view that manufacturing will contribute to economic growth in Q4. The BBA, on Thursday, reported that mortgage approvals rose in September, underpinning the positive outlook for the housing market. Sterling was also supported this week after comments from MPC member Bean at a talk on Tuesday suggested he may favour higher interest rates.

Reports on Friday that US gdp growth had slowed to just 1.6% in Q3 capped off a generally disappointing

€/\$ rallied to 1.275 after the weak US gdp data



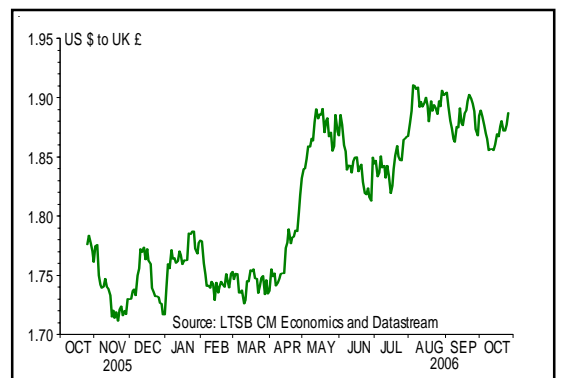
Financial market trends, ending Friday 27 Oct. '06

At 4.30pm 27 Oct. '06		Change from 20 Oct. '06 % change
FTSE 100	6160.9	+0.09%
Exchange rates		
US\$/UK £	1.8968	+0.86%
Euro €/UK£	1.4909	-0.08%
US\$/Euro €	1.2720	+0.81%
Swaps - 5 year (mid rate) basis points		
UK pound	5.23	-4.4
US dollar	5.12	-10.7
Euro	3.94	-1.4
Bond yields -10 year		
UK	4.59	-9.0
US	4.68	-10.0
Euro	3.81	-3.2

week for US data and pushed the dollar through some key technical trading levels. The growth rate was the weakest since Q1 2003, with falling residential investment alone shaving off 1.1%. However, early indications are that gdp growth should accelerate in Q4. The core PCE deflator eased to 2.3% in Q3 from 2.7% in Q2, however still remains above the Fed's stated 'comfort level'. News from the housing market was mixed, as existing homes sales fell but new home sales unexpectedly rose in September. The price of new homes showed a steep drop compared to the same time last year. A sharp rise in aircraft orders boosted total durable goods orders in September, however attention was taken by a poor outturn for the core component.

The euro was underpinned this week by a series of stronger than expected economic data, which helped to firm the view that interest rates are likely to rise again in December to 3.5%. German CPI inflation surprisingly rose by 0.2% in October and both German IFO business confidence and GfK consumer confidence were stronger than anticipated. EU-12 money supply growth accelerated to 8.5% in September, well above the ECB's reference rate of 4.5%, which it considers consistent with price stability.

£/\$ briefly pushed through 1.90 on Friday



Interest rate market review - bonds, cash and swaps

US interest rates left on hold at 5.25%, but a dovish FOMC statement and soft US Q3 GDP numbers pushed bond yields lower.

Rolling calendar of UK data releases and events

Industrial prod. (6/11)
Manufacturing output (6/11)
Trade balance (9/11)
Producer prices (13/11)
Consumer prices (14/11)
Unemployment (15/11)
Average earnings (15/11)

Rolling calendar of US data releases and events

Consumer credit (7/11)
Trade balance (9/11)
Uni of Michigan conf (9/11)
Wholesale inventories (9/11)
Producer prices (14/11)
Retail sales (14/11)
Business inventories (14/11)

Central bank meetings in 2006/2007

European ECB (3.25%)
2 November, 7 December, 11 January, 8 February, 22 February
US FOMC (5.25%) - 12 December, 30/31 January, 20/21 March, 9 May
UK MPC (4.75%) - 9 November, 7 December, 10 January, 8 February

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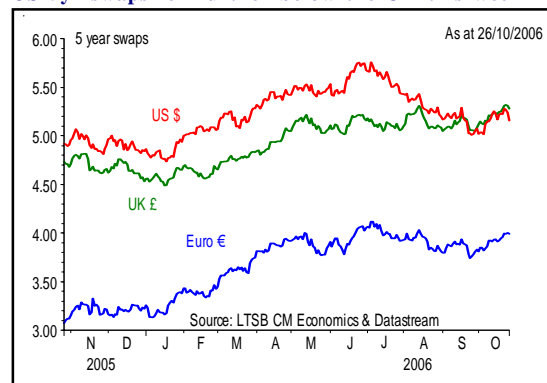
A dovish FOMC statement, weak underlying US durable goods orders and softer-than-expected US Q3 GDP growth put downward pressure on global bond yields in the past week. The FOMC statement on Wednesday called a halt to the backup in yields in the past month. As widely expected, US interest rates were left unchanged at 5.25%, but the accompanying statement noted that inflation seemed likely to moderate over time due to "reduced impetus from energy prices, contained inflation expectations and the cumulative effects of previous interest rate increases". US 2-year yields fell 3bps to 4.84% in immediate reaction to the FOMC statement, while 10-year yields fell 4bps to 4.76%.

Bond yields fell further on Thursday, following weak US durable goods orders data. Although headline orders jumped 7.8% on the month in September, this was distorted by an off-the-scale 183% rise in orders for civilian airplanes. Excluding transportation, orders registered a poor 0.1% rise, on the back of a steep 1.5% fall in August. US housing market data in the form of existing and new home sales, were mixed this week and their impact on the markets was relatively limited, though there may be broad signs that the sector is bottoming out.

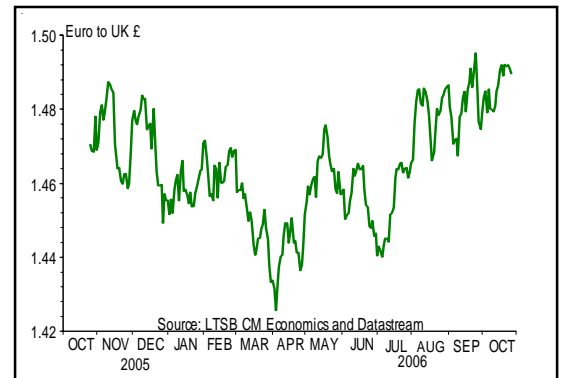
On Friday, the advance estimate of US Q3 GDP came in at 1.6%, weaker than the consensus call for 2.0%, and at the slowest pace of growth since Q1 2003. The core PCE deflator fell to 2.3% from 2.7% in Q2. US 2-year yields fell 3bps to 4.76% following the data release and 10-year yields fell 2bps to 4.68%. Over the week, US 2-year yields were down 10bps to 4.77%, 10-year yields fell 10bps to 4.68% and 5-year swaps declined 11bps to 5.12%. Demand for the auctions of 5-year TIPS and 2-year notes earlier in the week were decent, but 5-year notes on Thursday were less well received.

Developments in the US helped drive UK and eurozone 10-year bond yields lower in the past week. However, yields at the short end of the curve, such as 2-year yields, were supported by a rise in the German Ifo survey and stronger German CPI for October. EU-12 industrial orders, French business confidence and German GfK consumer confidence also rose, though Italian and Belgian business confidence edged lower.

US 5yr swaps fell further below the UK this week



£/€ in narrow range just below key 1.50 level



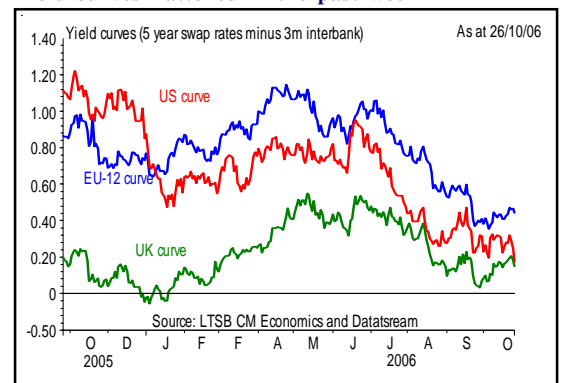
Hawkish ECB rhetoric also supported eurozone yields, particularly at the short end of the curve. The ECB's Wellink on Monday said that interest rates were still very low and Weber on Thursday warned that eurozone CPI may stay above 2% after 2007. It appears clear now that the ECB will raise interest rates by a quarter point to 3.5% by the end of this year. The ECB is reticent about the outlook for rates beyond that, but it seems likely that some further policy tightening will occur next year.

The UK was relatively quiet in the past week. Markets took little notice of the CBI industrial trends survey, which was nevertheless surprisingly weak, with the total orders balance falling to -20 in October from -5, while the BBA mortgage lending data showed a little weakening. Nevertheless, the BoE MPC's chief economist, Charles Bean, on Tuesday sounded hawkish. He said that the BoE should err on the side of caution to prevent higher inflation and that the deflationary impact of globalisation had waned in the past couple of years. A quarter point rate rise to 5% in November looks almost a done deal and we expect a further increase to 5.25% in Q1 2007. On the supply front, the 50-year index-linked gilt auction was well received, with a bid/cover ratio of 2.95.

Over the week, German 2-year yields rose 2bps to 3.72%, 10-year yields fell 3bps to 3.81% and 5-year swaps were down 1bp to 3.94%. UK 2-year yields fell slightly by 1bp to 5.06%, 10-year yields fell 9bps to 4.59% and 5-year swaps declined 4bps to 5.23%.

Jeavon Lolay, Senior Economist Hann-Ju Ho, Senior Economist

Yield curves flattened in the past week



FOREIGN EXCHANGE - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: £/\$ briefly rallied above 1.90 after the weak US gdp data

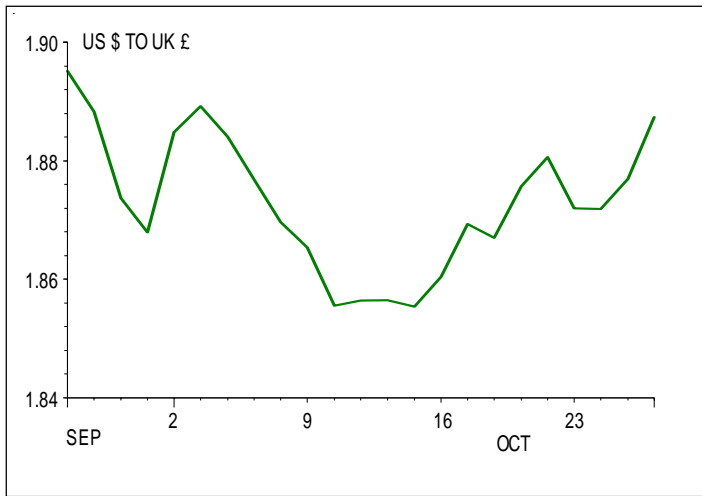


Chart 2: €/€\$ underpinned by economic data and weak US figures

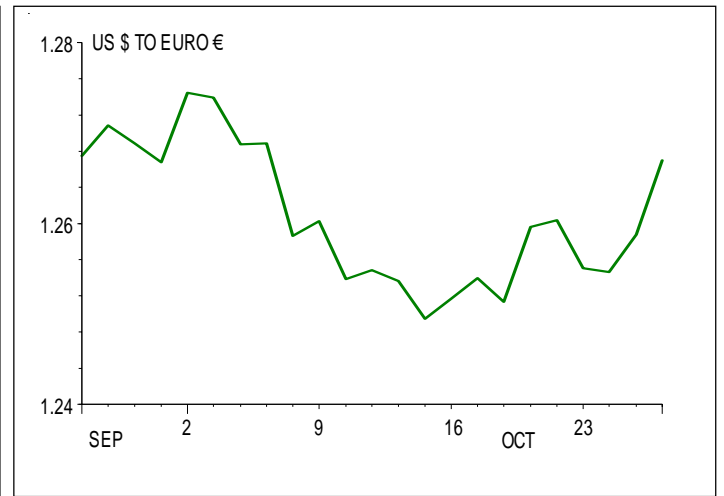


Chart 3: £/€ remained in a narrow range this week

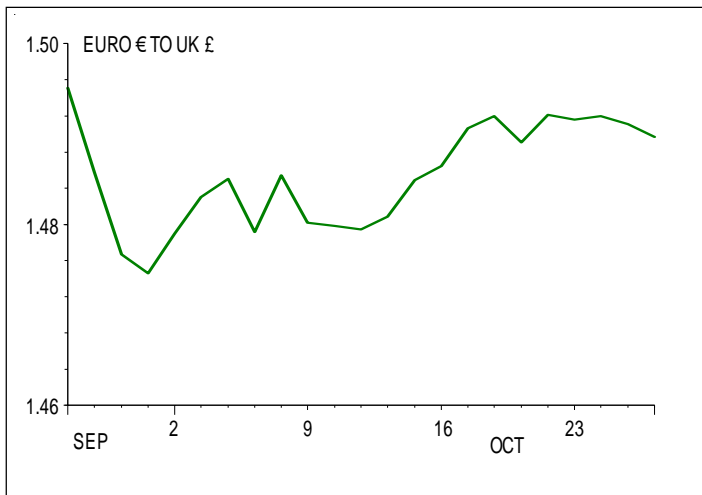


Chart 4: \$/¥ headed below 117.5 on Friday after the weak US data

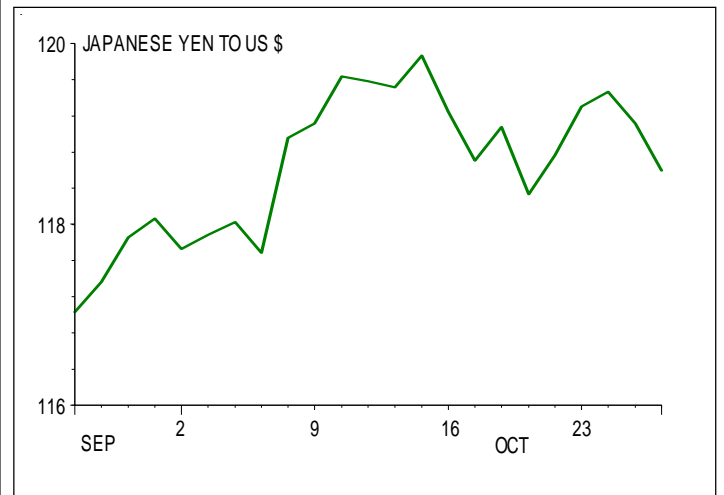


Chart 5: Loonie supported by recent rebound in oil prices

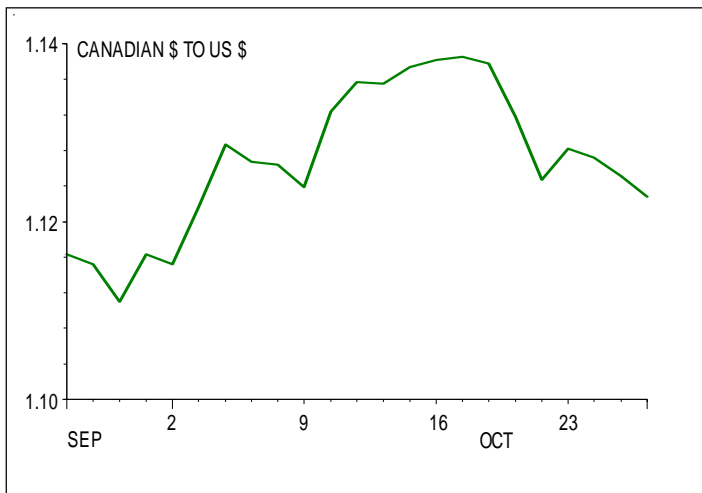
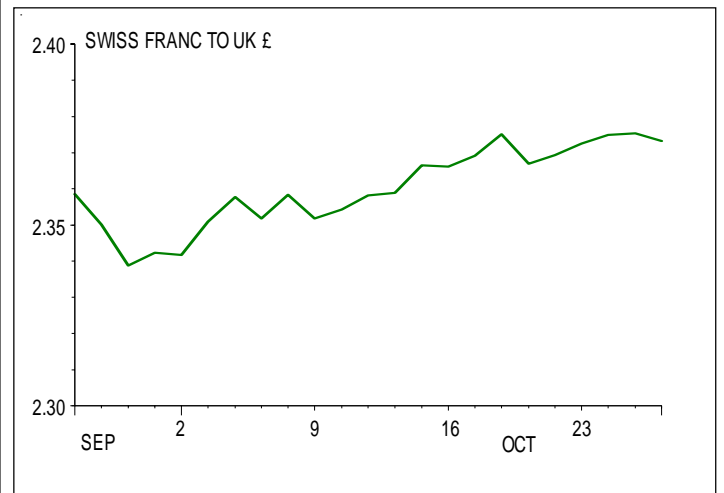


Chart 6: Swissie remained under selling pressure



FIXED INCOME - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: UK 2yr yields fell slightly from 4-year highs

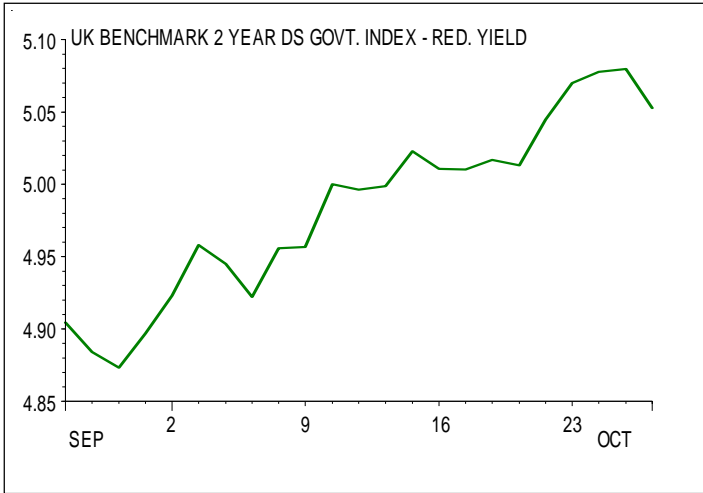


Chart 2: UK 10yr yields dragged lower by US developments

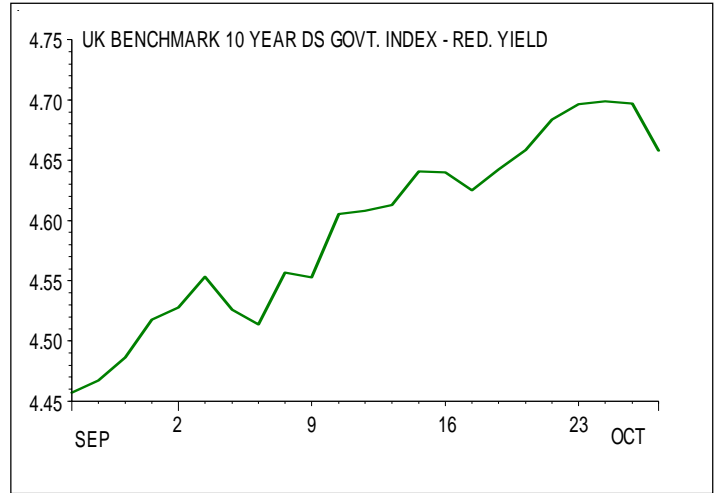


Chart 3: US 2yr yields fell below 4.80% after soft GDP numbers

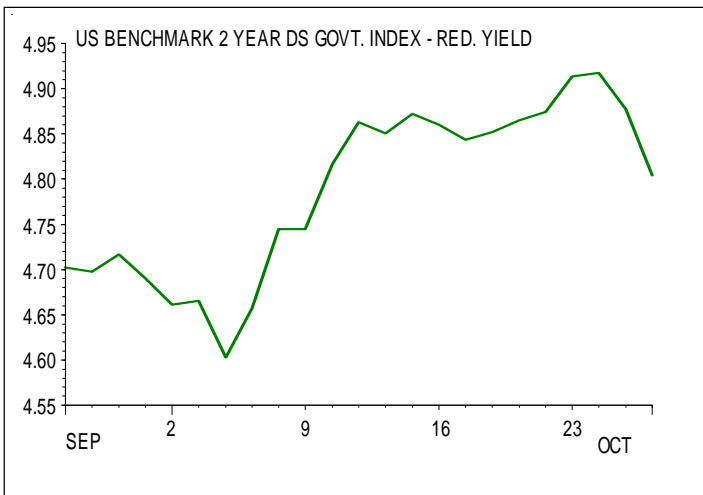


Chart 4: US 10yr yields headed below 4.70%

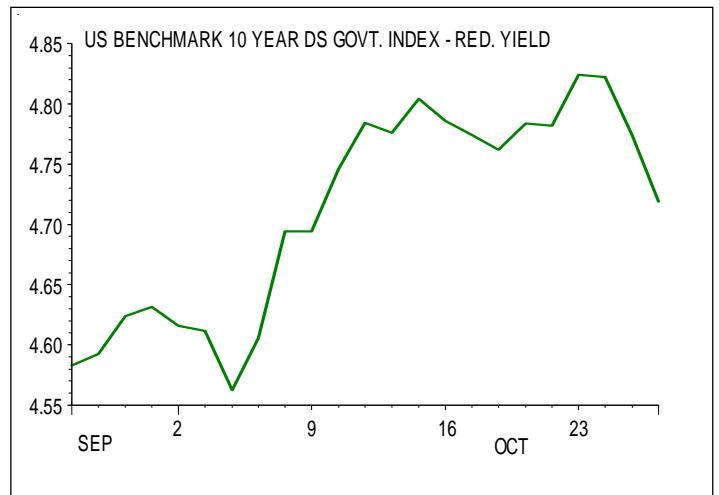


Chart 5: EU-12 2yr yields supported by stronger German Ifo survey

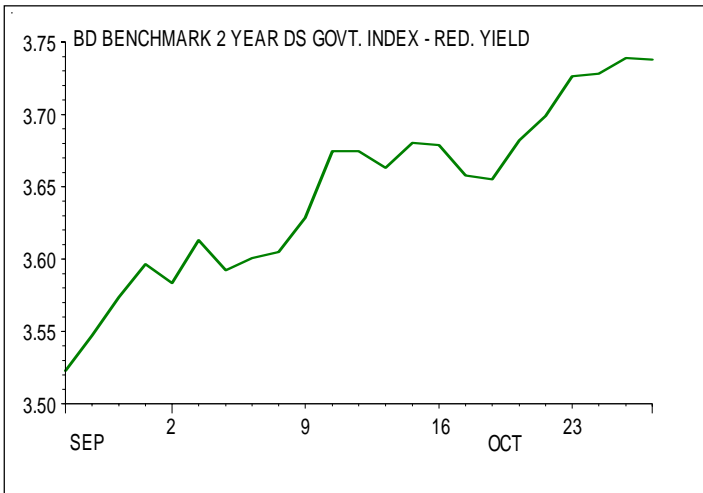
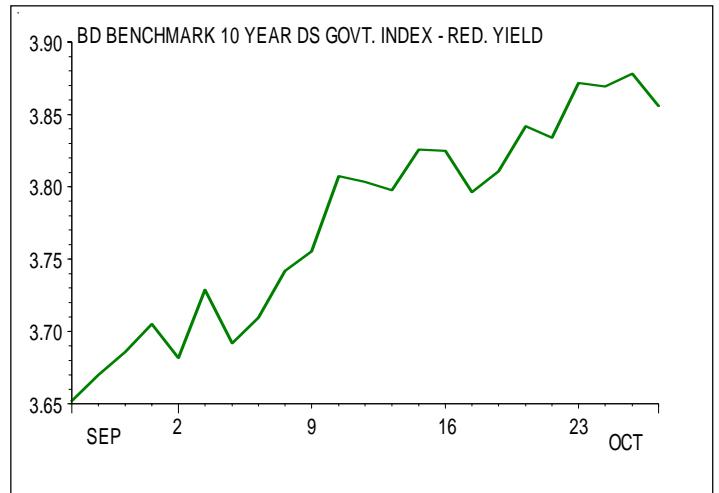


Chart 6: EU-10yr yields weighed by dovish US FOMC and GDP



INTEREST RATE MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

Chart 1: US 5yr swaps declined to 5.10% on Friday



Chart 2: EU-12 5yr swaps fell back from 4% peak earlier this week



Chart 3: UK 5yr swaps ended three-week gains

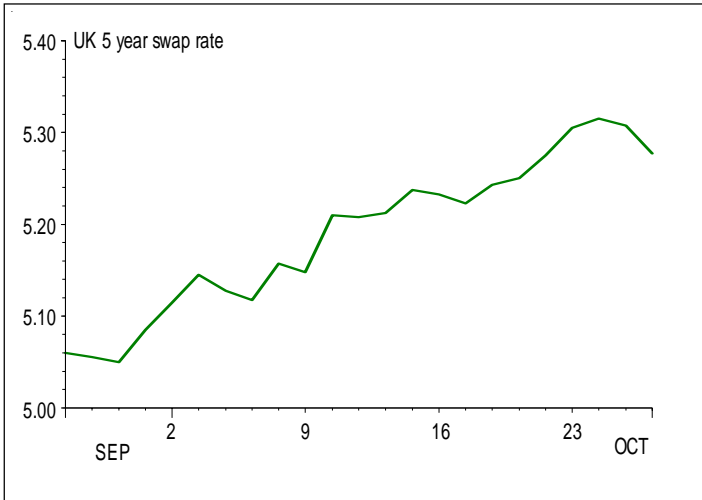


Chart 4: US yield curve flattened significantly in the past week

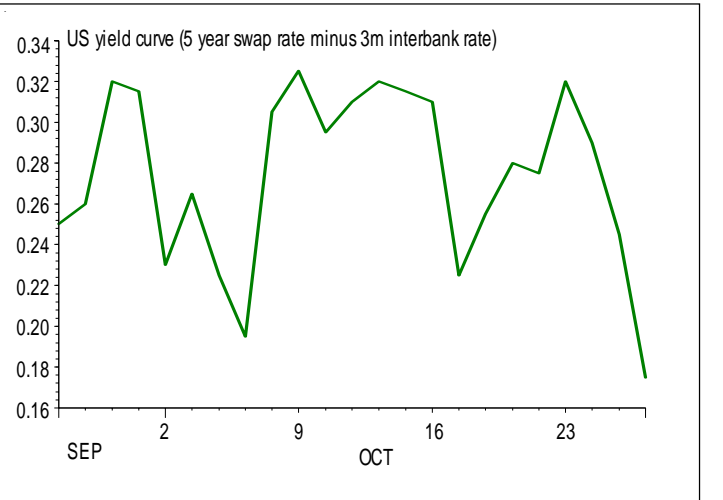


Chart 5: Eurozone yield curve flattened slightly last week

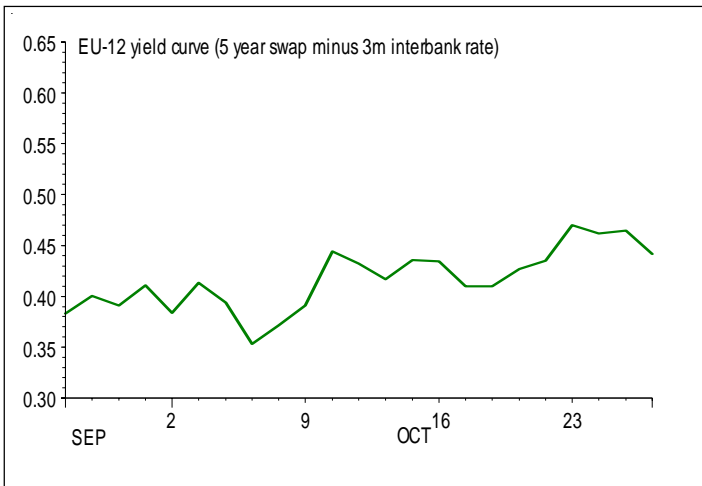
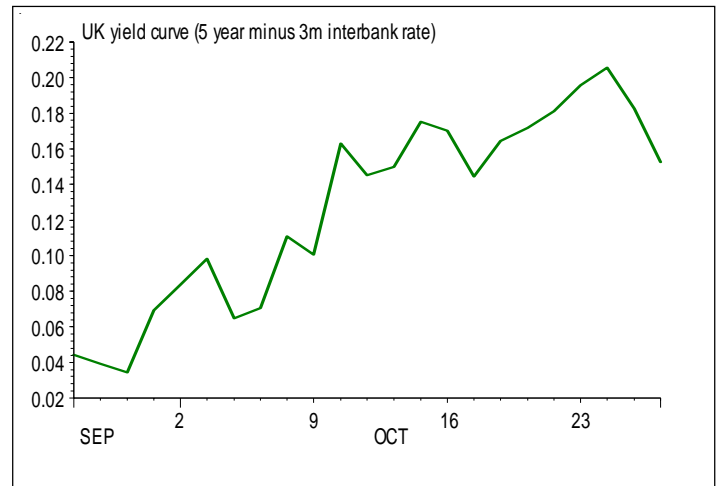


Chart 6: UK yield curve flattens, as 10-yr yields weighed by the US



KEY COMMODITY & EQUITY MARKETS - GRAPHICAL ANALYSIS RECENT TRENDS

Chart 1: Gold prices rebound back towards \$600

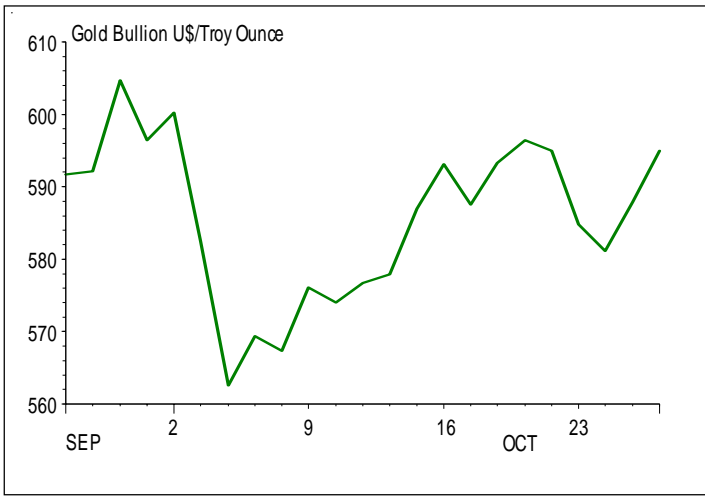


Chart 2: Oil prices rally after surprise drop in US inventories

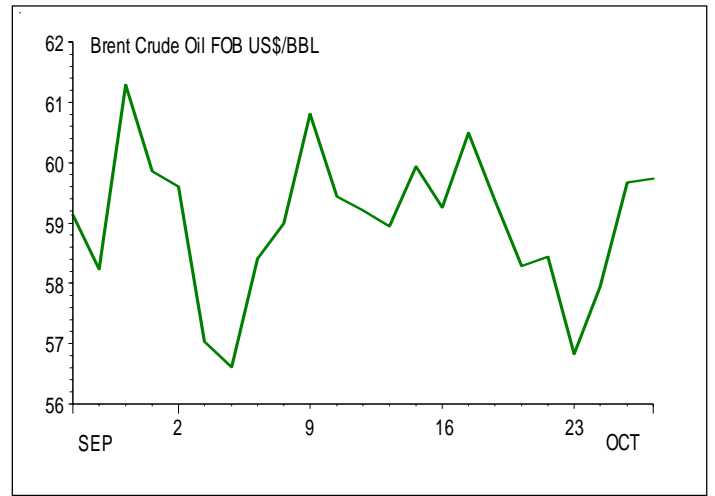


Chart 3: The FTSE 100 above 6,200 for first time since Feb 2002

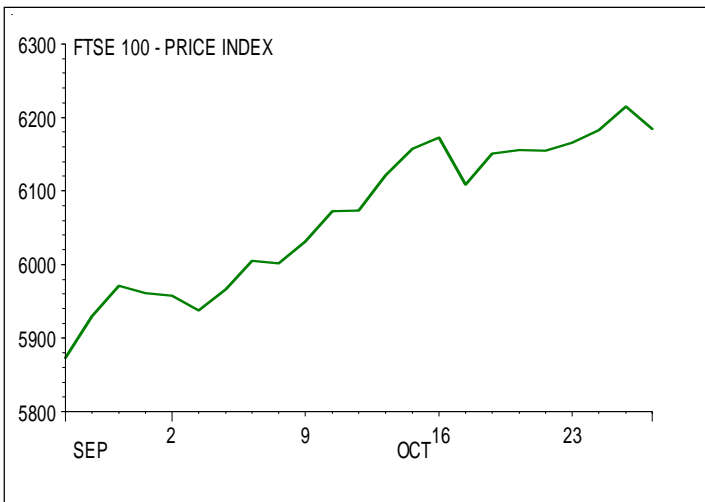


Chart 4: The Dow set a fresh record high this week

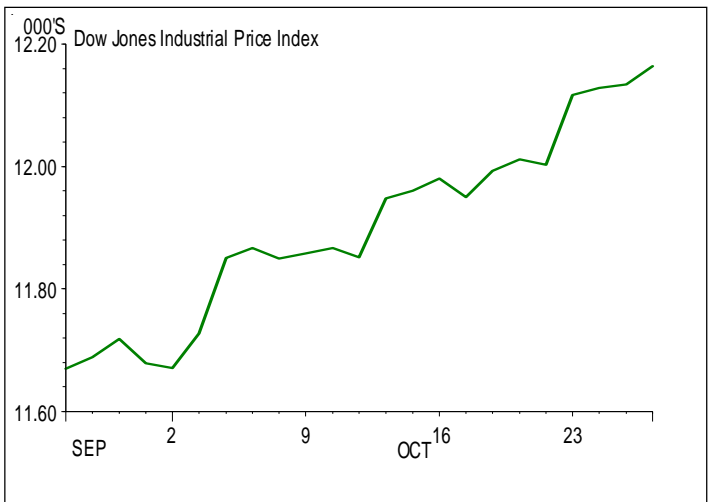


Chart 5: Nikkei-225 heads towards 17,000

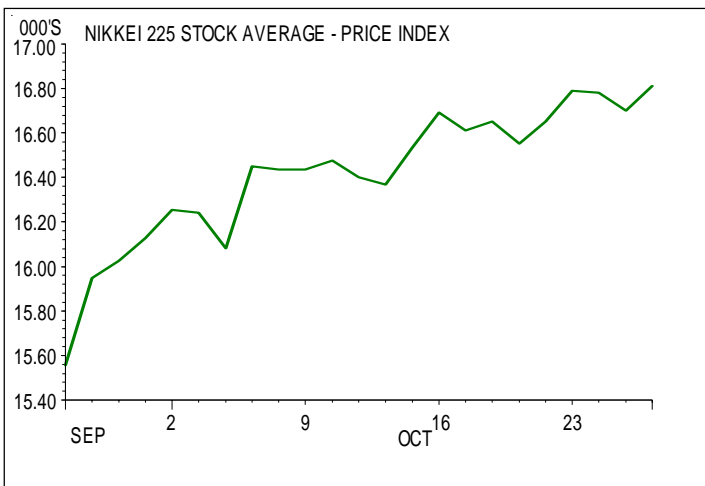
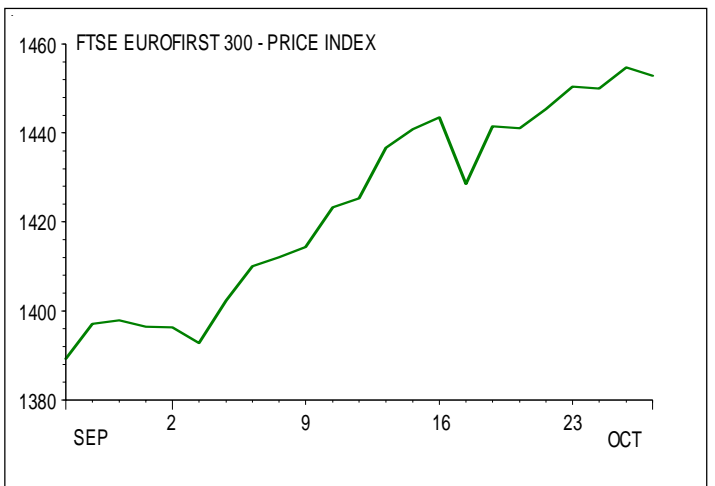


Chart 6: EU-12 equities extend gains on positive market sentiment



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