



22 September 2006

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## Financial Markets Review

### Oil prices fall to \$60 per barrel, US bond yields plummet

US interest rates were left on hold at 5.25%, but voting was not unanimous, leaving tightening bias intact. The BoE MPC minutes reinforced prospects of a rate increase in Q4.

Crude oil prices fell to \$60 in NY, the lowest level since March. Equities lost ground late in the week, reversing earlier gains.

#### Client support

Economic Research Team

Trevor Williams

0207 158 1748

trevor.williams@lloydstsb.co.uk

Nichola James

0207 158 1741

nichola.james@lloydstsb.co.uk

Jeavon Lolay

0207 158 1742

jeavon.lolay@lloydstsb.co.uk

Kenneth Broux

0207 158 1750

kenneth.broux@lloydstsb.co.uk

Hann-Ju Ho

0207 158 1745

hann-ju.ho@lloydstsb.co.uk

Rabia Bhopal

0207 158 1747

rabia.bhopal@lloydstsb.co.uk

Stuart Frost

0207 158 1744

stuart.frost@lloydstsb.co.uk

Distribution

Sarah Pedder, 0207 158 1746

Information Manager

Hugh Geen, 0207 158 1740

Customer sales

Andrew Willett

0207 158 1616

andrew.willett@lloydstsb.co.uk

John Haines

0207 158 1675

john.haines@lloydstsb.co.uk

Jeremy Hodges

0207 050 6006

jeremy.hodges@lloydstsb.co.uk

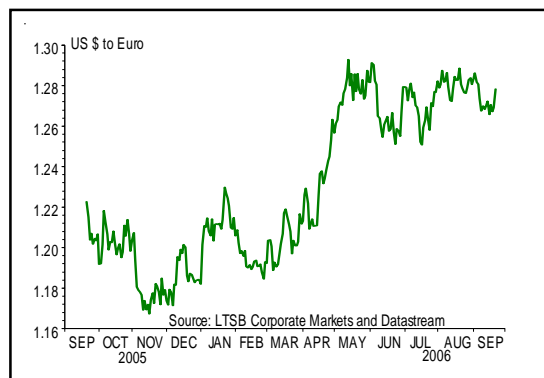
#### Financial market review - foreign exchange

The dollar fell this week, losing 1.3% against sterling and euro and 1% against the yen after market participants cut their expectations of higher US interest rates. Falling US producer price inflation and faltering manufacturing confidence prompted a dollar selling on Thursday and lifted £/\$ above 1.9050 and €/€\$ above 1.28. Sterling scaled the highest level since June 2005 against the euro (1.4916) after mildly hawkish BoE MPC minutes and an upbeat CBI industrial trends survey underscored the likelihood of a rise in UK interest rates to 5.0% before year-end. In emerging markets, the Thai baht posted its biggest one-day drop in four years on Tuesday following the military coup, but the currency swiftly recovered as participants played down the chance of a repeat of the 1997 meltdown.

Currency markets were trapped in narrow and familiar trading ranges over the first three days of the week, with participants reluctant to take on new positions ahead of the US interest rate decision on Wednesday. News on Tuesday of a surprise 0.4% decline in core US producer prices and fresh evidence of a slowing housing market initially weighed on the dollar.

The Federal Reserve, as expected, subsequently left interest rates on hold at 5.25% for a second successive meeting, but the vote for a rate increase by FOMC member Lacker left in place the tightening bias and protected the dollar from further selling. Earlier on Wednesday, it was confirmed that the BoE MPC voted 8-0 to keep interest rates at 4.75%, but extracts from the discussion revealed continuing concern among some committee members about rising inflation expectations, and reinforced perceptions that interest rates are on course to climb to 5.0% before year-end. £/\$ closed at 1.8886, in the middle of a 1 ½ month

#### €/\$ closes above 1.2800 thanks to weak US data



#### Financial market trends, ending Friday 22 Sept. '06

At 4.30pm 22 Sept. '06		Change from 15 Sept. '06 % change
FTSE 100	5822.3	-0.9%
Exchange rates		
US\$/UK £	1.9013	+1.3%
Euro €/UK£	1.4854	+0.04%
US\$/Euro €	1.2805	+1.3%
Swaps - 5 year (mid rate) basis points		
UK pound	5.10	-5.0
US dollar	5.05	-15.0
Euro	3.78	-10.0
Bond yields -10 year		
UK	4.50	-5.0
US	4.62	-14.0
Euro	3.70	-7.0

range. Sterling managed to carve out gains against the euro on Wednesday, lifting £/€ to 1.4888, the highest level since mid-November last year.

The major currency pairs broke out of two-week ranges on Thursday on the report of a sharp decline in US manufacturing confidence. The Philadelphia Fed survey nose dived into negative territory for the first time since April 2003, supporting talk of an economic slowdown. Heavy buying of treasuries caused yields to plummet and led futures markets to increase their bets that US interest have peaked. Underpinned by the earlier release in the day of a better than forecast UK CBI industrial trends survey – orders books rose to a 21-month high - £/\$ rose to a two-week high of 1.9063, extending its gain to 2.6% since September 11<sup>th</sup>. £/€ extended its rally on for a 3rd session to 1.4916 .

€/€\$ enjoyed its biggest one day gain this week since the end of June (+0.74%), boosted by a narrowing in US/EU interest rate differentials. A rise in the Belgian leading index on Friday helped €/€\$ to consolidate this week's gains above 1.28 and suggests the IFO next week may not track the ZEW down.

#### £/\$ briefly rallied above 1.9050 on UK rate outlook



US treasury yields fell 15bp this week on weaker manufacturing sentiment and speculation that the Fed tightening cycle is over.

### Rolling calendar of UK data releases and events

PMI manufacturing (2/10)  
 PMI services (4/10)  
 BoE decision (5/10)  
 Industrial prod. (6/10)  
 PPI (9/10)  
 Trade balance (10/10)  
 CPI (17/10)

### Rolling calendar of US data releases and events

ISM Manu. (2/10)  
 ISM Services (4/10)  
 Non-farm payrolls (6/10)  
 Consumer credit (6/10)  
 Budget statement (10/10)  
 Wholesale invent. (10/10)  
 Beige book (12/10)

### Central bank meetings in 2006

**European ECB** (3.00%)  
 5 October, 2 November, 7 December, 11 January, 22 February  
**US FOMC** (5.25%) - 24/25 October, 12 December  
**UK MPC** (4.75%) - 5 October, 9 November, 7 December,

Lloyds TSB Bank,  
 Economic research,  
 Corporate Markets  
 10 Gresham Street,  
 London EC2V 7AE

Switchboard:  
 0207 050 6045

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

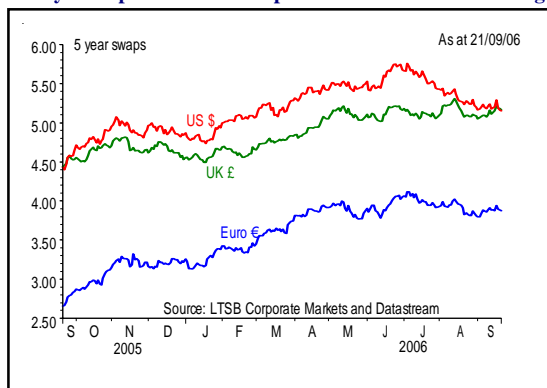
Weak US producer prices, housing starts and Philly Fed survey were the key drivers pushing yields and swap rates lower last week. The military coup in Thailand on Tuesday also sent yields lower due to safe-haven pressures, but the impact was limited. On the other hand, US capital flows data showed a fall in the net purchases of US securities in July to \$31.8bn, but this led to only a limited rise in yields earlier in the week.

The FOMC left interest rates unchanged at 5.25% on Wednesday, as expected. The accompanying statement sounded more dovish than the previous meeting, noting "a cooling of the housing market" and "reduced impetus from energy prices". However, Richmond Fed President Lacker dissented again and voted for a hike and the statement still left the door open for further policy tightening, should the data warrant it.

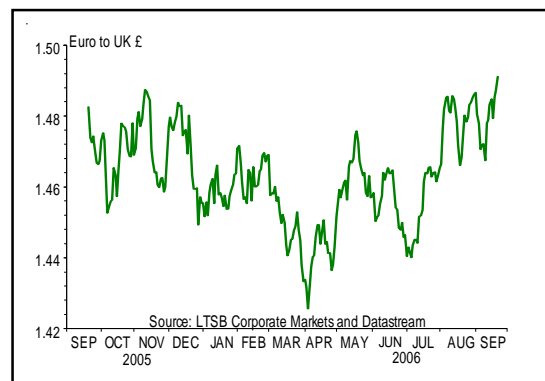
US yields actually moved higher in the immediate aftermath of the FOMC rate announcement, suggesting that markets may have been expecting a more dovish statement. Nevertheless, the general sentiment for lower yields remained intact, led by weak data earlier in the week, namely a second monthly fall in core PPI and a decline in housing starts to 1.665mn, the lowest in three years. The surprisingly strong reaction to a weak Philly Fed survey on Thursday underlined the current market sentiment and helped to push US 2- and 10-year yields to 4.68% and 4.62%, respectively, down more than 10bps on the week and to the lowest levels since March. The 5-year swap rate fell 15bps on the week to 5.05%, the lowest since February.

The broadly weak US data also helped to push yields lower in the euro area, though rates such as the 3-month were supported by hawkish ECB comments about inflation risks at the weekend and at the start of the week. The data flow supported the view that current economic activity in the euro area remains robust. French real household spending surged to 6.4%/y/y in August, while the current situation index of the German ZEW survey of analysts rose to 38.9 in September from 33.6, the highest for nearly six years.

### US 5yr swap rates fell on optimism inflation is slowing



### £/€ rose to the highest level since June'05 (1.4916)



However, the main expectations component of the ZEW survey, which usually leads the current situation index by about six months, continued to plummet, falling to -22.2 from -5.6 in August and a peak of 71 at the start of this year, weighed by fears of a US slowdown, stronger euro and a hike in German VAT.

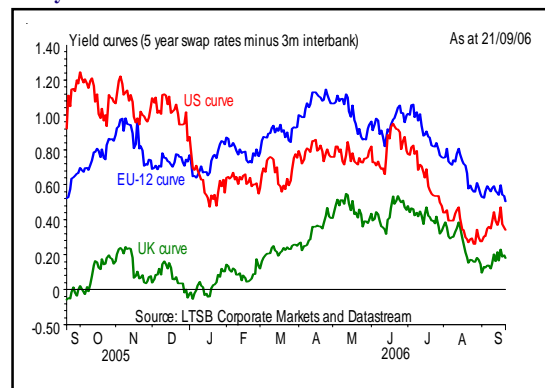
Overall, our view is that the economic situation in the euro area is positive and ECB rhetoric remains hawkish, but the ZEW survey indicates that financial analysts see darker clouds on the horizon. Over the week, the German 3-month interbank rate rose 3bps to 3.31%, but the 5-year swap rate fell 10bps to 3.78% and the 10-year yield fell 7bps to 3.70%, the lowest since March.

In the UK, the minutes of the September BoE MPC meeting revealed a unanimous 8-0 vote for no rate change, in line with expectations. The minutes indicated that MPC members were becoming increasingly concerned most about the pickup in inflation expectations. However, market expectations for the BoE to raise rates by 25bps to 5% in November were not materially changed. Official data indicated that housing market activity remained robust in August, while the CBI industrial trends survey showed a further improvement in total new orders to the highest level since December 2004.

Over the week, UK 2-year yields fell 5bps to 4.93%, while the 5-year swap rate declined 5bps to 5.10% and the 10-year yield fell 5bps to 4.50%, affected by developments abroad.

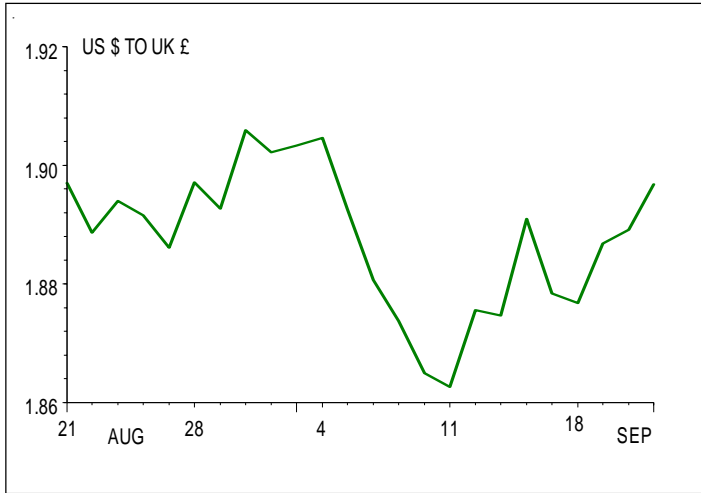
Hann-Ju Ho  
 Kenneth Broux

### UK yield curve inversion continued this week

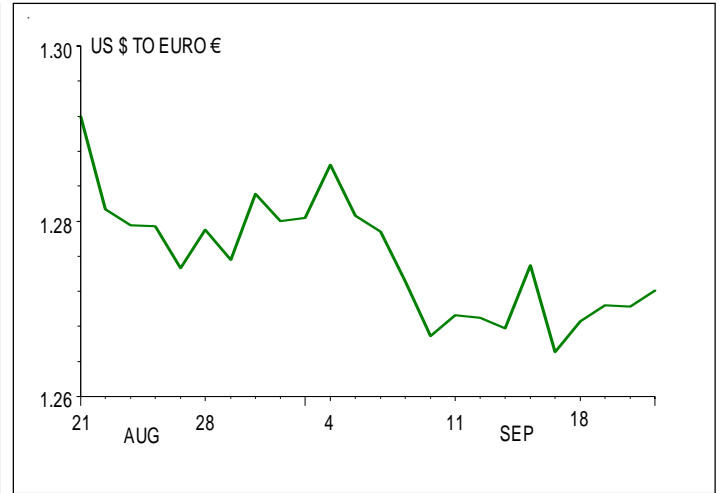


# FOREIGN EXCHANGE - GRAPHICAL ANALYSIS OF RECENT TRENDS

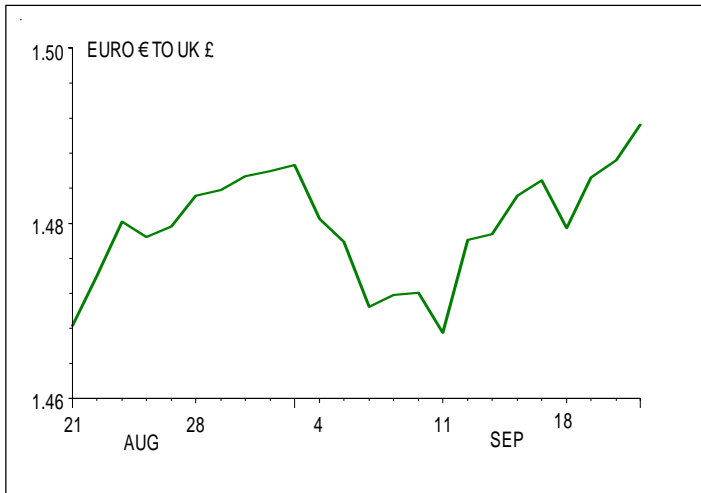
**Chart 1: £/\$ is up 2.5% in the last two weeks**



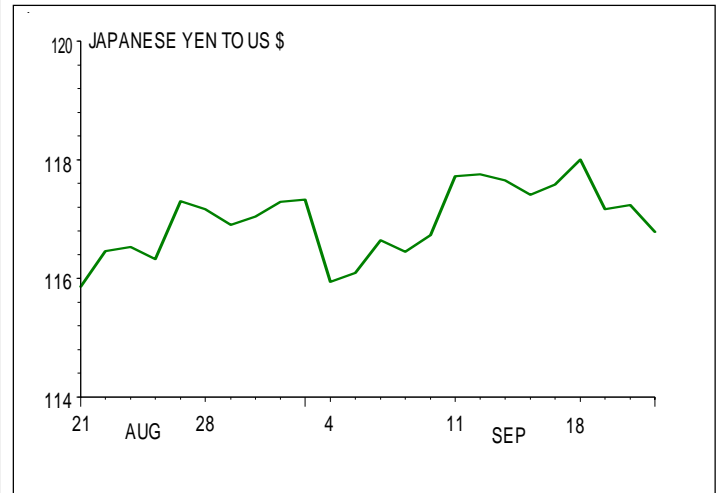
**Chart 2: €/\$ underpinned by weak US data, back above 1.28**



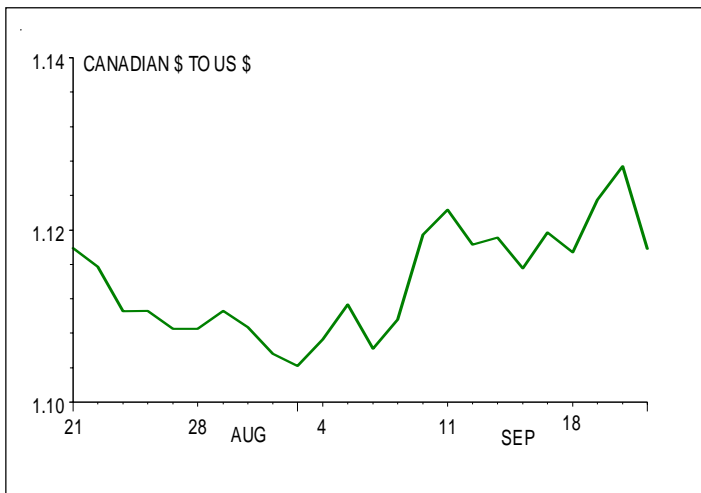
**Chart 3: Can £/€test 1.50 next week?**



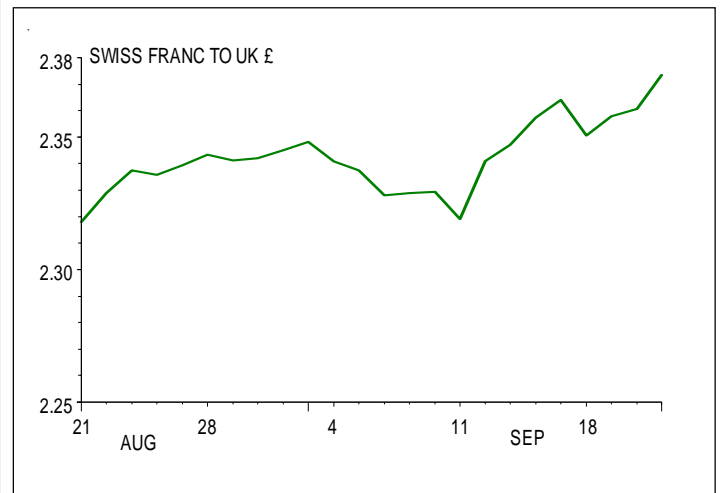
**Chart 4: \$/Y still within a narrow range of 116.0-118.0**



**Chart 5: \$/Cad reversed last week's gain, back below 1.12**

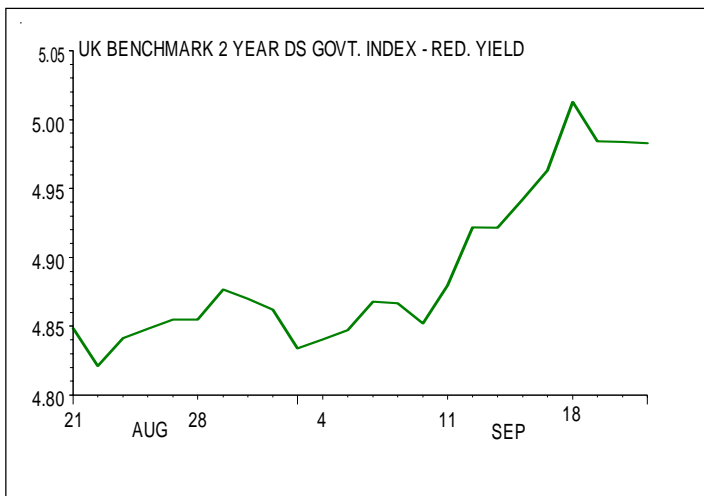


**Chart 6: Swissie scaled highest level since April 2004 (2.3776)**

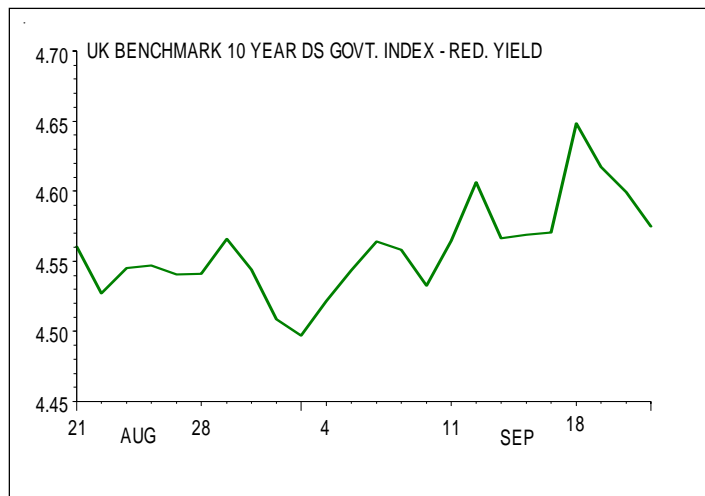


# FIXED INCOME - GRAPHICAL ANALYSIS OF RECENT TRENDS

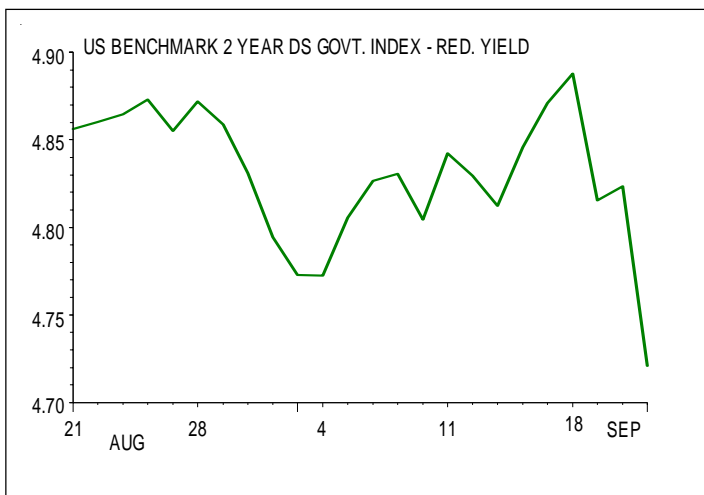
**Chart 1: UK 2yr yields hit 6-week high (5.03%)**



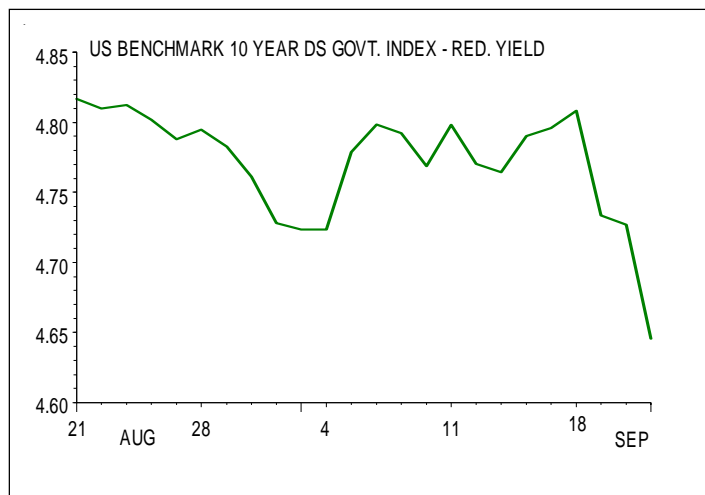
**Chart 2: UK 10yr yields dropped 12bp to 4.49% since Wednesday**



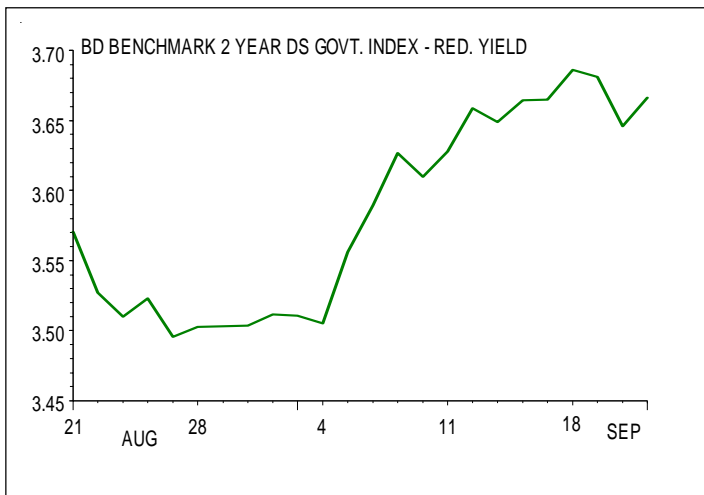
**Chart 3: US 2yr yields fell to a 9-month low (4.63%)**



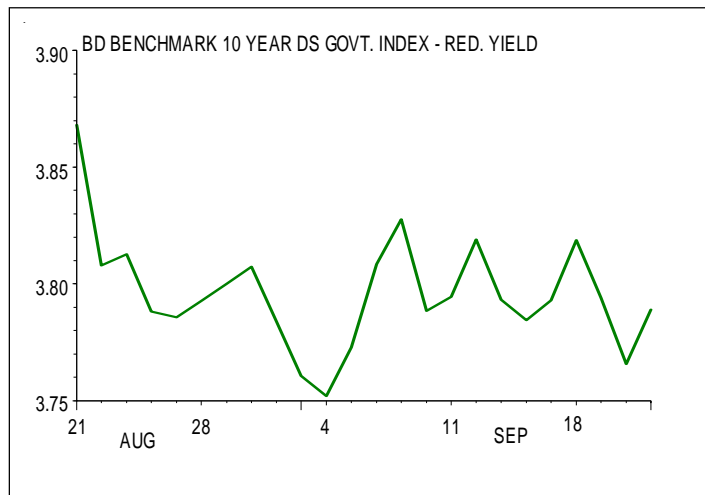
**Chart 4: US 10yr yields fell 16bp this week, testing 4.60%**



**Chart 5: EU-12 2yr yields ended the week down 12bp (3.54%)**

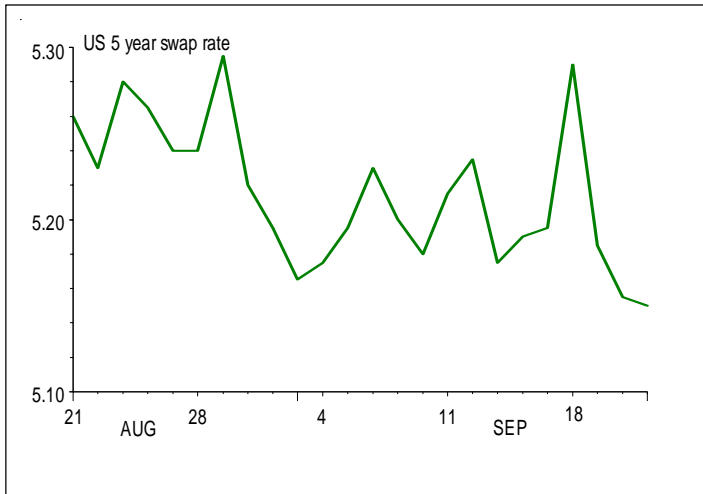


**Chart 6: EU-10yr yields touched a near 6-month low (3.69%)**

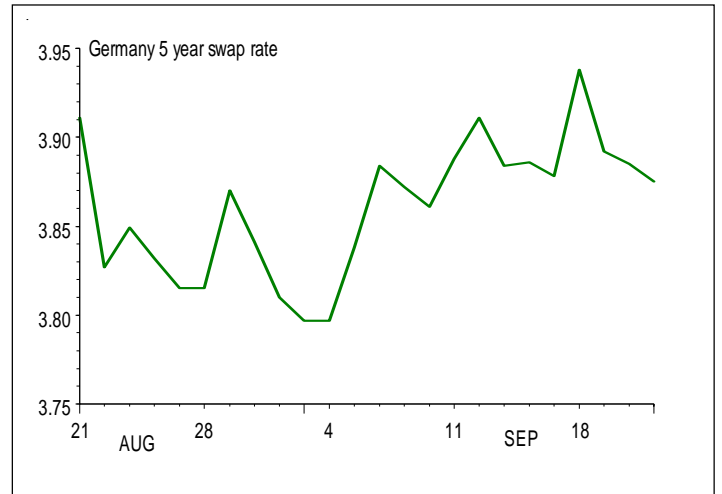


# INTEREST RATE MARKETS - GRAPHICAL ANALYSIS OF RECENT TRENDS

**Chart 1: US 5yr swaps plummeted 20bp to 5.04%**



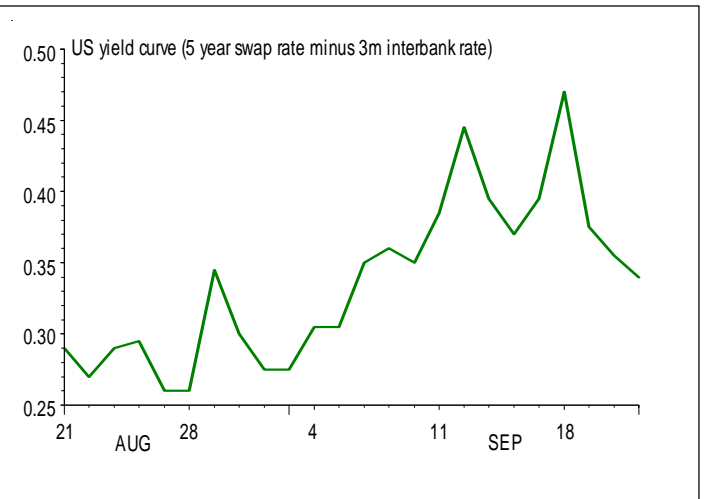
**Chart 2: EU-12 5yr swaps fell in sympathy with the US, down 15bp**



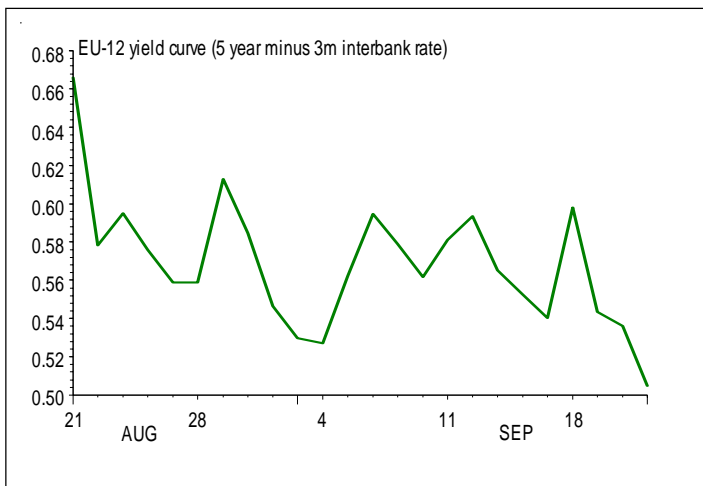
**Chart 3: UK 5yr swaps fell 5bp to 5.10%**



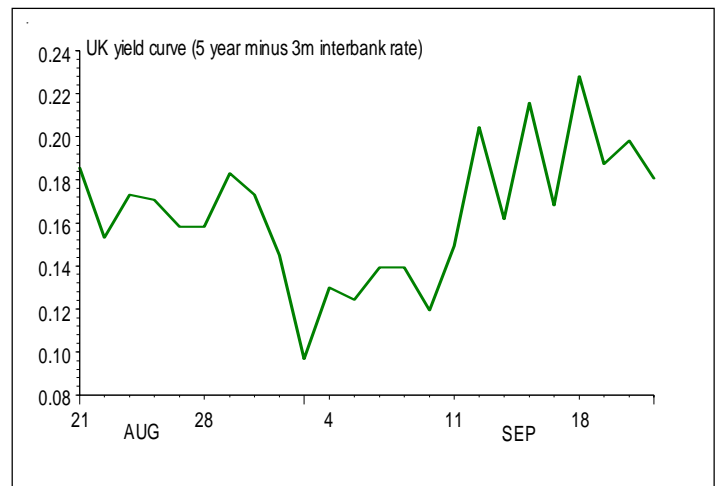
**Chart 4: US yield spread resumed narrowing trend**



**Chart 5: Euro zone yield spread narrowed as long yields fall**

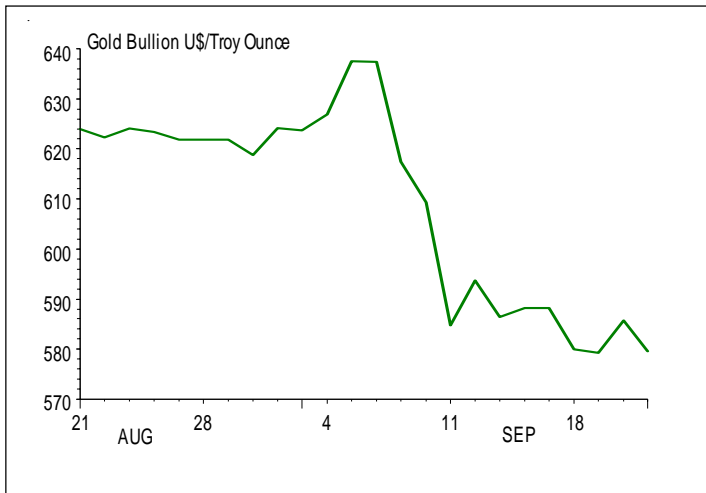


**Chart 6: UK yield spread stays relatively stable**

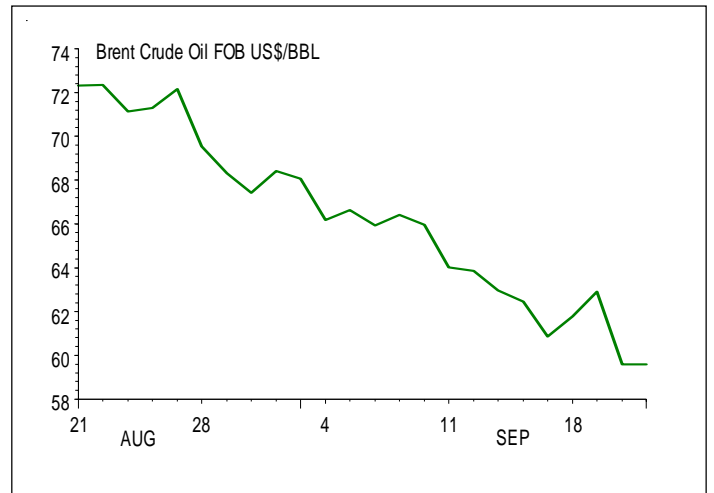


# KEY COMMODITY & EQUITY MARKETS - GRAPHICAL ANALYSIS RECENT TRENDS

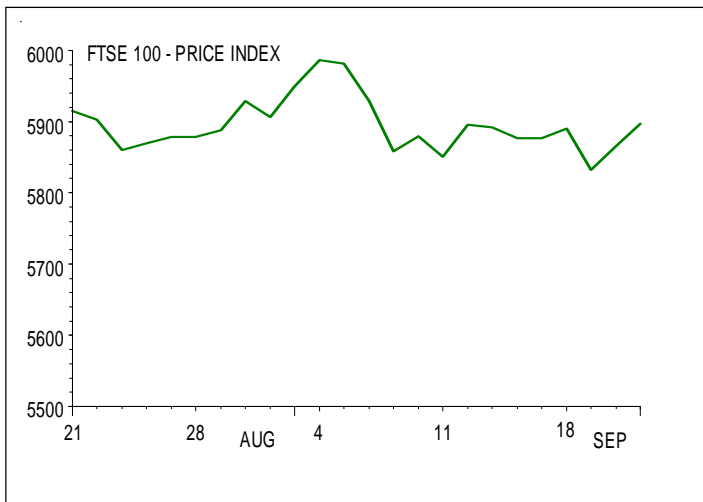
**Chart 1: Gold prices stabilised around \$587**



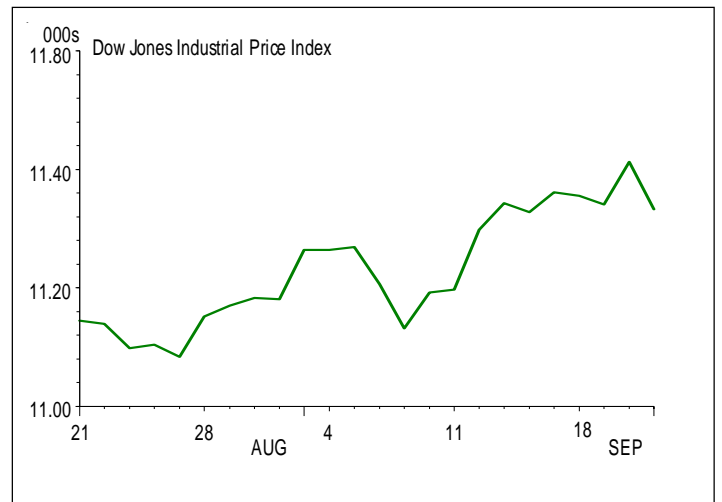
**Chart 2: Oil prices lowest since March (\$60)**



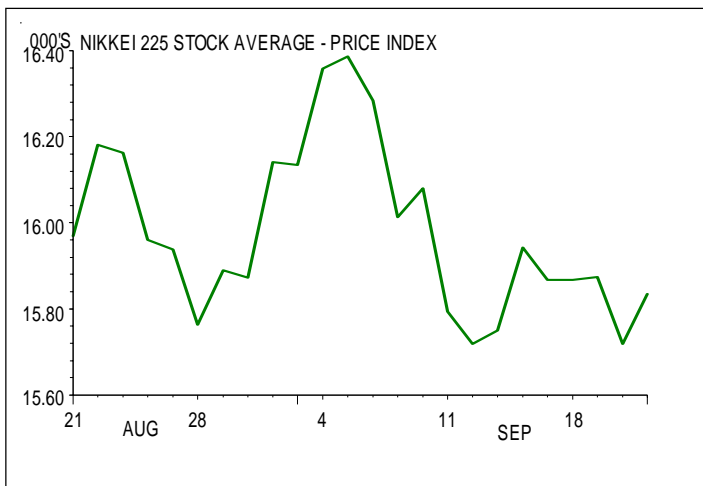
**Chart 3: The FTSE 100 closed below 5,900 reversing earlier gain**



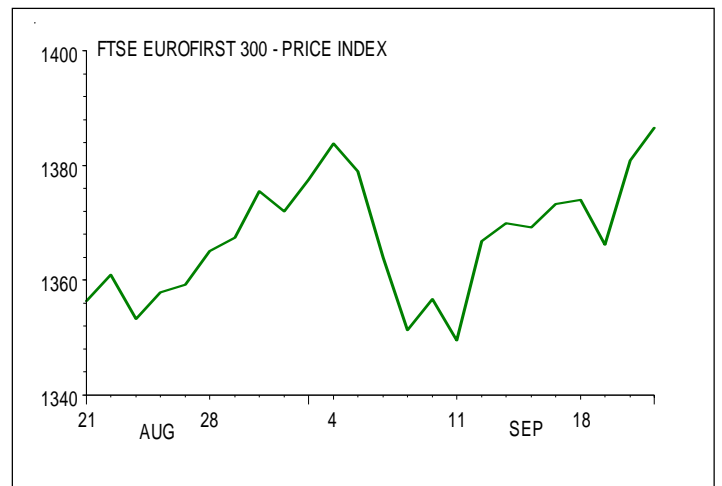
**Chart 4: Signs of economic slowdown weigh on Dow on Friday**



**Chart 5: Nikkei-225 failed to hold gains above 16,000**



**Chart 6: EU-12 stocks shrugg off prospect of higher interest rates**



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