

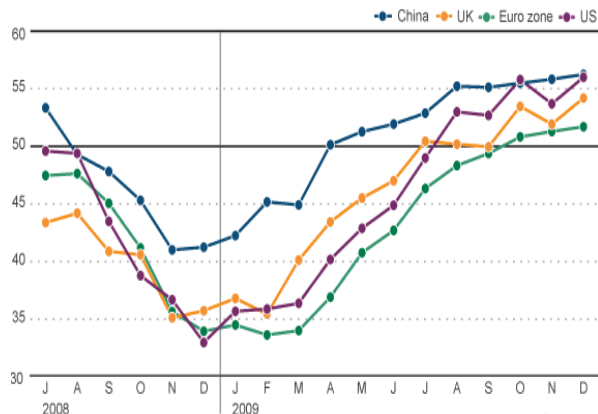
INSIDE DEBT

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Monday, January 4, 2010

CHART OF THE DAY

Global PMIs



Chinese manufacturing grew at its fastest pace on record in December, while U.S. factories marked their best month in nearly four years, suggesting more improvement in the world economy.

TODAY'S TOP NEWS

- U.S. manufacturing grows in Dec; Nov construction dips
- Fed's Duke sees low rates for "extended period"
- Pimco says cutting back U.S., UK rate exposure
- Global factory output picks up steam in December
- Argentina to launch debt swap in January
- Novartis seeks to buy rest of Alcon for \$39 bln
- Credit Suisse sued over resorts, \$24 bln sought
- Russia resumes oil to Belarus refineries

ECON WATCH

FOR TUESDAY JANUARY 5

ET	Indicators	Unit	Reuters	Prior
2:45	FR Consumer confidence	ind	-29	-30
4:00	DE Unemployment chng sa	k	5	-7
4:00	DE Unemployment total nsa	mln	3.30	3.215
4:00	DE Unemployment rate sa	%	8.1	8.1
5:00	EZ Inflation, flash yy	%	0.9	0.5
8:30	CA Producer prices mm	%	0.5	-0.3
8:30	CA Raw materials prices mm	%	1.2	2.5
10:00	US Factory orders mm	%	0.5	0.6
10:00	US Durable goods, R mm	%	-	0.2
10:00	US Durable gds ex-trn R mm	%	-	2.0
10:00	US Durables ex-def, rev mm	%	-	0.0
10:00	US Nondef cap ex-air R mm	%	-	2.9
10:00	US Pending sales chng mm	%	-2.0	3.7
18:59	US Domestic car sales	mln	3.90	3.87
18:59	US Domestic truck sales	mln	4.45	4.44
18:59	US Total Vehicle Sales	mln	11.00	10.88

MARKETS TODAY

TODAY'S TOP STORY: The U.S. manufacturing sector grew at its fastest pace in nearly four years in December, its fifth consecutive month of expansion, adding to hopes of economic improvement in 2010.

For more please [click here](#)

TREASURIES: U.S. Treasuries prices mostly rose, due to bargain hunting in the wake of a recent selloff driven by optimism over an economic recovery and worries over the impact of heavy issuance of government debt.

- 10-yr notes were up 4/32, yielding 3.82 pct, versus 3.84 pct.
- During Monday's offshore selling, 10-yr yields rose as far as 3.9 pct. Yields topping 3.918 percent would be the highest since early June.
- 30-yr bond prices fell 7/32 for a yield of 4.65 pct from 4.63 pct.
- 2-10's part of yield curve steepened by about 6 bps to 275 bps.

FOREX: The U.S. dollar fell as broad gains in stock and commodity prices encouraged investors to seek riskier, higher-yielding investments at the expense of the greenback.

- Dollar index fell 0.44 pct to 77.521.
- The euro rose 0.34 pct at \$1.4409, recovering from earlier falls, which took it as low as \$1.4258.
- Against the yen, the dollar traded down 0.23 pct at 92.56 yen, giving up gains which lifted it to a four-month high of 93.21 yen.
- Sterling gained 0.09 pct at \$1.6092, earlier hitting the day's high of \$1.6242 after a stronger-than-expected UK data.

CORPORATES: U.S. corporate bond spreads tightened on an improving outlook for companies' profits after a report showed manufacturing activity grew for a fifth straight month in December.

- The CDX.IG-13 index tightened by 1 bps to about 82 bps.
- U.S. investment grade corporate bonds gained nearly 20 pct in 2009, the strongest performance since 1995, according to Bank of America Merrill Lynch indexes.

STOCKS: U.S. stocks climbed in a commodities-fueled rally after data showed the manufacturing sector expanded for a fifth straight month, lifting confidence in a global economic recovery.

- Dow rose 1.50 pct to 10,583.96, S&P gained 1.6 pct to 1,132.99 and Nasdaq climbed 1.73 pct to 2,308.42.
- Alcoa Inc rose 3.29 pct to \$16.65, while oil and gas producer Apache Corp added 2.62 pct to \$105.87.
- Valero jumped 6.81 pct to \$17.89, and Sunoco advanced 6.02 pct to \$27.67. The PHLX Oil Service index climbed 3.87 pct to 202.47.
- Intel Corp rose 2.35 pct to \$20.88.

C & E: Oil rose more than 2 pct to touch two-month highs over \$81 a barrel as cold weather battered the United States and other big consumer regions, driving up demand for heating fuel.

- Crude oil was up 2.78 pct to \$81.57 per barrel, after touching \$81.68, the highest level since Oct. 23.
- Gold gained 2.13 pct to \$1,119.65 an ounce.
- The Reuters-Jefferies index was up 2.1 pct at 289.34.

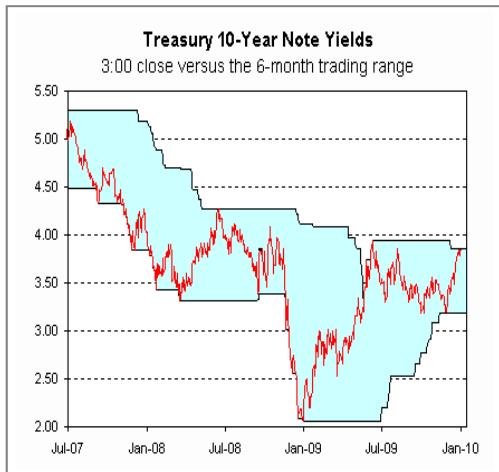
• For MARKET SNAPSHOT [click here](#)

• For NEXT UP [click here](#)

• For DEEP DIVE [click here](#)



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.055	0.02	0.056	0.002
3-Mo Bill	0.065	0.050	0.066	0.004
6-Mo Bill	0.175	0.165	0.178	-0.016
1-Year	0.403	0.400	0.409	-0.030
2-Year	99.820	99.852	1.092	0.105
3-Year	98.539	98.578	1.636	0.125
5-Year	99.859	99.906	2.656	0.141
7-Year	99.250	99.297	3.371	0.094
10-Year	96.172	96.234	3.845	-0.055
30-Year	95.391	95.453	4.662	-0.438

EQUITIES

	INDEX	CHANGE
DJIA	10595.97	169.59
NASDAQ	2306.89	38.24
S&P 500	1133.26	18.32

OIL

	PRICE	CHANGE
NYMEX	81.6	2.2
BRENT	80.3	2.4

EURODOLLAR FUTURES

	CLOSE	CHANGE
Jan-10	99.740	0.003
Mar-10	99.655	0.000
Jun-10	99.375	0.000
Sep-10	98.995	0.000

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.190	O/N	0.190
2-Week	0.190	2-Week	0.220
1-Month	0.200	1-Month	0.210
3-Month	0.220	3-Month	0.240
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.180	10:00 AM	0.120
2-Week	0.200	3:00 PM	0.119
1-Month	0.200		
3-Month	0.230		

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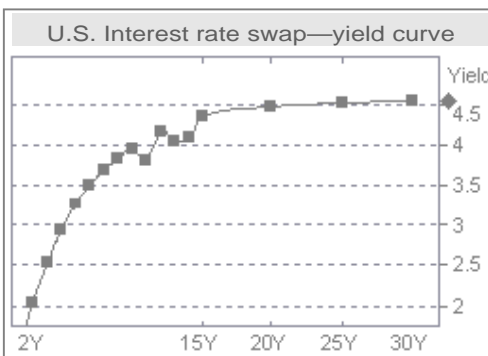
	SPREAD		RATE	
2-Year	25.75	29.75	1.34	1.36
3-Year	35.75	39.75	1.98	1.99
5-Year	26.75	30.75	2.92	2.92
7-Year	10.75	14.75	3.47	3.47
10-Year	9.25	13.25	3.93	3.91
30-Year	-15.25	-11.25	4.51	4.48

FUTURES

	PRICE	CHANGE
CBOT 5 yr	114.55	0.17
CBOT 10 yr	115.52	0.06
CBOT 30 yr	115.06	-0.31

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.130	0.160	-	-
1-Month	0.230	0.320	0.132	0.142
3-Month	0.250	0.450	0.155	0.165
6-Month	0.350	0.650	0.198	0.208
12-Month	0.900	1.300	0.453	0.463



CURRENCIES

	BID	ASK
Euro	1.4409	1.4412
Sterling	1.6090	1.6094
JP Yen	92.59	92.62
Swiss Franc	1.0296	1.0300
Can Dollar	1.0422	1.0428
Mexico	12.8819	12.8876

FED FUNDS NYFRSM - 10AM

Open	0.1400	1m	0.2255
High	0.1400	3m	0.2630
Low	0.0700		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	12.5	11	1.22
3-Year	1.75	10/08/2012	-1.5	-2.25	1.62
5-Year	2.625	20/11/2014	17	16.5	2.83
7-Year	5.125	18/10/2016	15	9	3.52
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	37	36	5.03

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	0	6	-
3-Year	1.375	09/01/2013	30	0	1.95
5-Year	3	28/07/2014	3	1	2.69
7-Year	5.25	15/09/2016	14	13.25	3.51
10-Year	3.75	27/03/2019	17	16	4.01
30-Year	6.25	15/07/2032	37	0	5.03

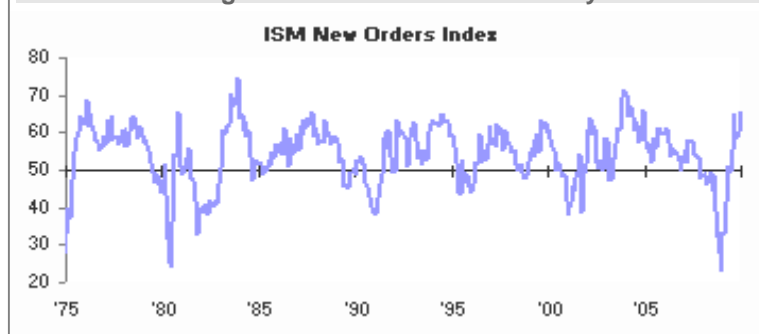
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	104.2100	104.2300	2.944
FHLMC	5.0	104.2000	104.2200	2.956

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	104.2400	104.2600	3.304
FHLMC	5.5	104.2500	104.2700	3.249
GNMA	5.5	104.2800	104.3000	3.821

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

U.S. manufacturing grows in Dec; Nov construction dips

The U.S. manufacturing sector grew at its fastest pace in nearly four years in December, its fifth consecutive month of expansion, adding to hopes of economic improvement in 2010.

But headwinds for the U.S. economy remain, as a separate report showed construction spending fell in November to a more than six-year low, depressed by a decline in homebuilding.

The focus, though, was on the Institute for Supply Management's national factory index, which rose to 55.9 in December from 53.6 in November.

That was the highest reading since April 2006, when the index stood at 56.0. A result below 50 indicates contraction, and a number above 50 means expansion.

The U.S. Commerce Department said construction spending fell 0.6 percent in November. The decline to \$900.1 billion, the lowest level since July 2003, was the seventh straight month of weakness in the industry.

Spending on private home building dropped 1.6 percent, the biggest decline since June, after rising 4.8 percent the prior month.

Pimco says cutting back U.S., UK rate exposure

Pacific Investment Management Co is cutting back its interest rate exposure in the United States and Britain, the fund said in a report on its outlook for 2010.

Managing Director Paul McCulley said the supply/demand balance for U.S. and British government debt was likely to suffer as governments stepped up borrowing, and as buying by central banks eventually declined.

"We're probably going to have a \$1.4 trillion deficit this year without the Fed on the buy side of the market for duration," he said of U.S. Treasuries, in a report on Pimco's website.

But Pimco remains "modestly bullish" towards interest rate exposure in the euro zone, which has not expanded fiscal policy so aggressively, and where central bank buying of longer-term debt will not shrink so much in 2010, McCulley added.

McCulley predicted sturdy growth in emerging market economies, slower growth in developed countries, and excessively low levels of inflation in the developed world because economies there still faced huge gaps between their actual and potential levels of output.

Argentina to launch debt swap in January

Argentina expects to launch in late January a swap to mop up \$20 billion in defaulted bonds, Economy Minister Amado Boudou told Reuters on Friday.

Boudou said the country "will probably" get more than 60 percent acceptance rate in the swap.

The exchange is part of Argentina's efforts to clean up problems left over from its massive sovereign default eight years ago, enabling it to issue new global bonds and ease tight financing in 2010 when its debt obligations rise steeply to some \$13 billion.

Retail bondholders, such as pensioners in Japan and Italy, own some 25 percent of the outstanding defaulted bonds and will be given a lighter discount and more time to consider the offer, the minister said.

He said the offer will include a seven-year bond to compensate for the accumulated interest investors missed out on by not entering a 2005 swap.

The government plans to promote the swap in the coming weeks in cities including New York, San Francisco, Tokyo, Paris and Zurich among others, Boudou said.

U.S. Fed's Duke sees low rates for "extended period"

The U.S. Fed sees a moderate economic recovery continuing in 2010, but needs to keep interest rates "exceptionally low" for an "extended period" to foster job growth, a Fed policymaker said.

Fed Governor Elizabeth Duke said in remarks prepared for delivery to an economic outlook forum that resource utilization in the economy is likely to remain below historical norms for some time, helping to keep inflation subdued.

She noted that there were still strong headwinds in the housing market, which is being buffeted by high numbers of foreclosures, tight credit for home builders and reduced mortgage availability for some households.

She said credit also remains tight for businesses, and her outlook for continued growth depends on further progress in repairing financial markets and restoring the flow of credit to households and businesses.

Separately, Fed Chairman Ben Bernanke said on Sunday, the U.S. economy is only now recovering from recession, and Fed Vice Chairman Donald Kohn warned the pace of recovery will be slow.

Bernanke said in a speech to the American Economic Association, that policy makers can no longer eliminate rate increases from their arsenal to prevent future crises.

The U.S. Senate is poised to begin debate over financial rules reforms that would peel away the Fed's authority for regulating large financial firms.

Global factory output picks up steam in December

Chinese manufacturing activity expanded at the fastest rate on record in December and the recovery among European manufacturers, led by Britain, gathered pace, according to key surveys.

The final Markit Eurozone Manufacturing Purchasing Managers' Index for December rose to 51.6 from 51.2 in November, its highest level since March 2008.

In China, the HSBC PMI rose to 56.1 from 55.7 a month earlier to reach its highest level since the survey began in April 2004.

The CIPS/Markit PMI for the UK hit a 25-month high of 54.1 last month, smashing forecasts for a rise to 52.0, while the euro zone saw output expand at its fastest pace in 27 months.

Euro zone growth was boosted by activity in Germany which expanded at its fastest pace since May 2008, while activity in France and Italy also ticked up from November, underlining the region's escape from a deep recession.

Growth in Japan's manufacturing activity picked up for the first time in three months in December.

By contrast, Russia's PMI fell to 48.8, the lowest in five months, from 49.1 in November.

Novartis seeks to buy rest of Alcon for \$39 bln

Novartis aims to buy the rest of leading eye care firm Alcon for \$39.3 billion to reduce reliance on prescription drugs, but is offering minority shareholders a worse deal than major owner Nestle.

The Swiss drug maker said it was exercising an option to buy a further 52 percent from the world's largest food group for \$28.1 billion, boosting its stake to 77 percent.

Novartis also aims to buy out the 23 percent held by minority shareholders for \$11.2 billion, ending uncertainty over whether or not it would seek full control.

Novartis is offering minorities 2.80 Novartis shares for each remaining Alcon share, which amounts to \$153 per share, based on Dec. 30 prices, versus the \$180 agreed with Nestle.

TODAY'S TOP NEWS

Under Swiss law, Novartis can force through the deal once it takes majority control from Nestle as mergers require approval of two-thirds of shareholders and a simple board majority.

Nestle said separately the deal would allow it to launch a new 10 billion Swiss franc (\$9.64 billion) share buyback program for two years once its existing 25 billion program is completed this year.

Credit Suisse sued over resorts, \$24 bln sought

Credit Suisse Group AG has been sued by property owners in four luxury ski and golf resorts, saying the Swiss bank concocted a loan scheme to defraud them and ultimately take over the properties.

The lawsuit filed on Sunday in federal court in Boise, Idaho, seeks \$24 billion of damages against Credit Suisse and commercial real estate firm Cushman & Wakefield Inc, and class-action status for more than 3,000 investors who bought land or homes.

Credit Suisse spokesman Duncan King said: "We believe the suit to be without merit and will defend ourselves vigorously." Cushman & Wakefield spokesman Dwayne Doherty declined to comment, saying the firm had not reviewed the lawsuit.

According to the complaint, Credit Suisse violated federal racketeering laws by concocting a "loan to own" scheme that inflated the value of resorts and burdened the resorts and purchasers of homes there with too much debt.

Using appraisal methods provided by Cushman & Wakefield, this scheme allowed Credit Suisse to win "enormous fees" and ultimately foreclose on or take control of the resorts at well below market value, the complaint said.

Russia resumes oil to Belarus refineries

Russia said it had resumed supplies to refineries in Belarus, but tensions are still simmering in a dispute over oil deliveries between the world's biggest energy producer and its ex-Soviet neighbor.

After meeting Sechin, Prime Minister Vladimir Putin said he hoped to clinch a deal with Belarus over oil supplies sometime soon, Interfax said.

But Minsk earlier today warned it may cut electricity supplies to Russia, ratcheting up tensions in the dispute between the two ex-Soviet countries.

That has raised the specter of another winter of supply disruptions for European Union customers such as Germany which buys 15 percent of its oil from Belarus's arm of the Druzhba pipeline.

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German Q3 exports to China beat trend-stats office

German exports to China surged ahead in the third quarter of 2009 while overall exports fell, the Federal Statistics Office said. Exports to China rose 14.5 percent from July through September compared to the same period a year earlier, reaching 9.8 billion euros. That compared to a 19 percent drop in overall exports, which stood at 200.2 billion euros.

Beijing's economic stimulus packages and looser monetary policy have driven the increase, said Commerzbank economist You-Na Park.

"This clearly boosted Chinese demand... the fiscal stimulus should continue in 2010, but not as strong as in 2009 and it will probably run out in the second half of the year," she added.

Chinese officials have repeatedly pledged in recent weeks that the country will maintain its "appropriately loose" monetary policy while also enhancing flexibility, which many analysts see as a signal of its intention to step up mild tightening.

Germany has been the world's biggest exporter of goods since 2003 but China is expected to overtake it soon.

Liquidity keeps interbank rates at record low

Copious liquidity in the euro zone banking system kept overnight interbank lending rates near record lows on the first day of trading in the new year, while three-month euro Libor was fixed at a record low.

The three-month London Interbank Offered Rate was fixed at 0.65375 percent by the British Bankers Association earlier, while the dollar equivalent edged off a record low of 0.25063 percent it had been pitched at for three successive days.

"The euro rate is continuing to fall in the short term as the market is still flush with liquidity in euros, and the European Central Bank has made things quite clear that this situation is unlikely to change in the short term," said Peter Chatwell, a market analyst at Calyon in London.

Monday's trade suggested a glut of cash pumped into money markets by the ECB is still keeping down bank-to-bank lending costs in an ebbing credit crisis which began 2-1/2 years ago and led to a global economic recession.

NEXT UP

Factory orders seen up, Pending homes sales seen down

U.S. factory orders are expected to have risen while pending home sales is expected to have fallen in November according to a Reuters poll.

U.S. factory orders is seen up 0.5 percent in November, 0.1 percentage points less than in October, when the data beat expectations and showed inventories at U.S. factories increasing for the first time in more than a year - a sign that manufacturers are ramping up production. Expectations ranged between a fall of 1.1 percent to an increase of 1.5 percent.

Analysts expected pending home sales to have fallen by 2 percent, reversing October's 3.7 percent gain and underscoring the on-again, off-again recovery in the housing market. Forecasts ranged from a fall of 15 percent to an increase if 4 percent.

U.S. auto sales seen up in December

U.S. auto sales are expected to have ended 2009 on a slight upswing, capping a year that saw General Motors and Chrysler collapse into bankruptcy and China overtake the U.S. as the biggest car market. The poll suggests December will mark a third consecutive month of modest growth in sales on the annualized basis favored by industry analysts. A gradual recovery in auto sales may be on the cards for 2010, but sales rates will probably stay well below figures not imagined by even the most pessimistic of analysts two years ago, industry analysts say.

U.S. light vehicle sales are expected to be down nearly 40 percent in 2009 from the most recent peak of nearly 17 million in 2005 -- and only because "cash for clunkers" incentives boosted sales sharply in July and August. U.S. auto sales on average are expected to come in at an 11 million unit adjusted annualized rate in December, according to the survey of 33 analysts.



DEEP DIVE Commentary and Analysis

COLUMN-Asia leads world trade recovery

By John Kemp

World trade volumes are picking up rapidly, in line with the rebound in manufacturing activity. The fastest gains are in Asia and other emerging markets, with the advanced economies lagging far behind.

Trade volumes shrank 20 percent in just six months from their peak in July 2008 to the post-crisis trough in January 2009, according to the Netherlands Central Planning Bureau. The Bureau compiles the most widely-watched indicator of world trade growth, based on 23 OECD economies and around 60 developing countries, accounting for 97 percent of all trade.

But in the nine months to October, volumes rebounded 9 percent. Volume is still down 12.5 percent from the peak, back to the level last reported in August 2006, wiping out more than two and a half years of growth. It has however reversed about half the previous loss, and the sustained improvement points to a stabilization in global activity levels.

The problem is that most of the renewed growth is concentrated in emerging markets, especially China and the rest of Asia. Improvement in the developed economies is feeble. While emerging market import volumes are down 8 percent on pre-crisis levels (just 1 percent in Asia) volumes into the United States, Japan and the euro zone are down almost twice as much (around 15 percent each).

The export picture is more balanced. Most advanced and developing economies are off around 15 percent from before the crisis, with Japan the notable outlier, off 22 percent.

UNEVEN IMPORT DEMAND

Several factors account for the regional differences:

(1) If the crisis of 1997-98 was caused by excessive dependence on short-term capital flows in emerging markets, the crisis of 2007-2009 has been firmly located in the banking systems and real estate sector of the advanced economies. It has largely bypassed the developing world, except to the extent it has cut external demand for their manufactured products and raw materials. Banking and credit systems in the emerging world remain basically intact and functioning, in contrast to developed-country counterparts.

(2) Stimulus measures appear to have been much more successful in Asia, where government spending has been delivered faster and state-directed bank lending is up strongly, in contrast to slow disbursement of funds and continued credit squeeze in the OECD.

(3) Trade credit remains tighter than before the crisis, but the total freeze which threatened to cause trade to break down in the second half of 2008 has eased, unblocking basic flows. Fear-driven de-stocking along the supply chain has also run its course and been replaced by the need to rebuild inventory to workable levels.

On the surface, exchange rates have not, so far, played a major role realigning import and export shares. The performance of the United States (which benefited from dollar devaluation in the first half of last year) and the euro zone (which did not) has been broadly similar in terms of both imports and exports. In any event the dollar-euro rate is now back above pre-crisis levels.

To the extent competitive devaluation benefited the United States, it simply offset the deeper crisis in the U.S. financial system and economy at the start of last year compared with the stronger economies at the core of the euro zone.

Asian exporters with currencies linked to the dollar probably received a larger benefit, helping them boost exports to the euro zone to offset declining demand from North America.

CURRENCY REALIGNMENT

It is very unlikely the United States and the core economies of Europe can generate enough demand from internal sources to achieve a strong, self-sustaining recovery.

Banking systems remain broken with artificially cheap central bank funding hiding the poor state of bank assets. Consumers and businesses are still over-indebted. In Europe, Germany's export-oriented economy remains dangerously dependent on strong growth overseas.

The only lasting solution is for a significant and sustained appreciation of emerging market currencies, led by China's renminbi - effectively a devaluation of the dollar, euro and yen -- to promote domestic consumption in Asia and export growth in the United States and Europe.

The financial crisis has achieved the first leg of the global rebalancing which economists and policymakers have talked about for the last ten years, by opening up a pool of spare capacity in the advanced economies to allow them to boost exports. It has achieved what an IMF crisis-lending team would term "expenditure reduction".

Now it needs to be accompanied by an "expenditure-switching" policy shifting the advanced economies towards exports and the emerging markets to domestic demand. That requires new monetary arrangements, including a long-term devaluation of the dollar and rise of the renminbi.

Currency realignment is the only way to stimulate purchasing power in the emerging economies effectively while forcing greater saving and an end to overspending in the advanced countries. Once it happens, it will cement the shift in purchasing power and the centre of gravity in the world economy from west to east.

-- John Kemp is a Reuters columnist. The views expressed are his own --

China starts slowly in 2010 race against inflation

By Simon Rabinovitch and Zhou Xin

China's central planners won last year's race, rushing to shore up growth before collapsing exports dragged down the economy.

They have adopted less urgency in their approach to this year's race: taming inflation before it takes off on the back of super-charged growth.

Beijing has started to trim back ultra-loose policies adopted at the height of the global financial crisis in late 2008. But these have been tentative steps, marginally in the direction of tightening, and pressure is building for more decisive action.

A clear sign of potential trouble came in the first data points of the new year. Surging factory orders and output pushed both of China's purchasing manager indexes to fresh highs, but the surveys also revealed very strong rises in prices.

Policymakers and investors who ignore the warnings about inflation would be doing so at their own peril. After all, a jump in Chinese PMIs in early 2009 was one of the best leading indicators of the country's ultimately stunning recovery.

"We are probably at a tipping point when news of very strong growth is not necessarily welcomed anymore as inflationary pressures are clearly rising quickly," Yu Song, an economist with Goldman Sachs in Hong Kong, said.

Consumer prices in November rose 0.6 percent from a year earlier after falling for most of 2009.

Inflation is set to rise in the coming months, partly due to the base effect of low prices a year earlier, but also because money supply grew at a record pace of roughly 30 percent last year.



DEEP DIVE Commentary and Analysis

The question is whether inflation will start to moderate around the middle of 2010 -- the baseline forecast of many analysts -- or turn into more of a headache.

Economists at Morgan Stanley, for example, forecast that annual consumer price inflation will crest at 3.6 percent at the end of the second quarter before falling to an average of 2.1 percent in the fourth quarter.

TENTATIVE TIGHTENING

It is by no means too late for Beijing to tamp down on the price pressures. Much will rest on how it applies bank lending controls -- a far more important tool than interest rates in Chinese monetary policy.

Record new bank credit in 2009 of nearly 10 trillion yuan (\$1.5 trillion) was heavily concentrated in the first half. This is the usual lending pattern in China and one that the government is determined to break, insisting in recent pronouncements that banks lend more evenly throughout this year.

So all eyes will be on new loans data in the first quarter.

Loans of more than 1 trillion yuan a month could fuel steep price rises and signal "drastic tightening" down the road, Yu said. But if officials succeed in controlling lending, the economy will be on its way to achieving high growth and low inflation, he said.

Chinese leaders from Premier Wen Jiabao to central bank governor Zhou Xiaochuan have pledged in recent weeks that they will maintain appropriately loose monetary policy while also "enhancing flexibility". Observers have interpreted this as an indication of their intention to gradually step up tightening.

Indeed, over the past month, Beijing has scaled back a tax exemption on property sales, increased a tax on auto purchases, vowed to crack down on speculation in the sizzling housing market and given banks stricter lending guidelines.

"There is no doubt that the government is heading in the correct direction and it chose the right time to start, but the most chal-

lenging point is how to control the pace of tightening," Gao Shanwen, an economist at Essence Securities in Beijing, said.

MANAGING LIQUIDITY

The central bank has also started using open-market operations to delicately tighten policy. It has conducted net cash drains from the market for 12 straight weeks, including in a surprise reverse repurchase agreement on the last day of 2009.

Yet, basic liquidity management should not be confused with more serious tightening. About 2 trillion yuan, more than one-quarter of China's annual 2009 budget, had been due to be allocated in December; the central bank needed to mop up some of the cash sloshing about as a result.

"The government is unlikely to take extremely aggressive tightening measures in 2010, as it is still not fully confident about the foundations of the economic recovery," Gao said.

Few analysts think the People's Bank of China will raise banks' reserve requirements or interest rates until headline inflation really catches the public's attention, perhaps sometime late in the second quarter.

Currency appreciation would, in normal circumstances, help serve tightening goals. But Beijing seems almost paralyzed by fears that a strengthening yuan would attract currency speculators, the hot money inflows revving up inflation.

Zhang Ming, an economist at the Chinese Academy of Social Sciences, the top government think-tank, forecast that the yuan would rise by less than 5 percent against the dollar this year. Offshore forwards pricing suggests investors currently expect the yuan to appreciate about 2.7 percent.

"We can rule out the possibility of a big one-off revaluation," Zhang said. "And, of course, if the dollar's real effective exchange rate increases, then the yuan will have less need to appreciate against it."

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