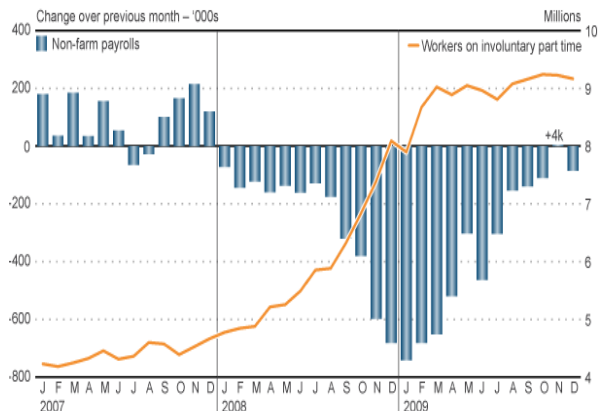


CHART OF THE DAY

U.S. non-farm payrolls



U.S. employers unexpectedly cut 85,000 jobs in December while economists forecast that payrolls would be unchanged, cooling optimism on the labor market's recovery and keeping pressure on President Barack Obama.

TODAY'S TOP NEWS

- U.S. employers slash jobs in Dec, pressuring Obama
- Two Fed officials say jobs key to exit strategy
- U.S. lawmakers press for Geithner AIG testimony
- Obama awards \$2.3 bln clean energy tax credits
- UPS raises outlook, sets job cuts; shares jump
- Euro zone jobless jump, Q3 GDP may spell momentum loss
- New Japan finmin backtracks on yen after PM rebuke
- Foreign trade buoys German economy in November
- UK factory gate inflation gathers pace in December
- Canada jobs recovery stalls in December

ECON WATCH

FOR MONDAY JANUARY 11

ET	Indicators	Unit	Reuters	Prior
02:45	FR Industrial output mm	%	0.5	-0.8
08:15	CA House starts, annualized	k	160.0	158.5
08:30	CA Building permits mm	%	-4.3	18.0
10:00	US Employment Index	ind	-	90.8
18:50	JP Bank lending yy	%	-	0.2
18:50	JP Current account NSA	%	62.8	42.7
	JP Market Holiday - Coming of Age Day			

MARKETS TODAY

TODAY'S TOP STORY: U.S. employers cut 85,000 jobs in December, confounding expectations the labor market was finally stabilizing and piling pressure on President Barack Obama to spur job growth.

For more please click here

TREASURIES: Shorter-dated U.S. Treasury prices rose after data showed the economy lost jobs unexpectedly in December, leading investors to pare back bets on future rate hikes by the Federal Reserve.

- 10-yr Treasury prices rose 3/32 for a yield of 3.82 pct from 3.83 pct.
- 30-yr bonds fell 9/32 in price to yield 4.7 pct from 4.69 pct.
- 2-yr Treasury yields fell to 0.97 pct, after touching a two weeks low of 0.95 pct.
- The spread between two-yr note yields and 10-yr note yields widened to 286 bps, surpassing the record closing wide level of 284 bps from late December.

FOREX: The dollar fell broadly after an unexpected drop in U.S. December nonfarm payrolls sparked worries about the economy's recovery and dented expectations interest rates will rise anytime soon.

- Euro was up 0.68 pct at \$1.4415, after jumping to a high at \$1.4439.
- Against the yen, the dollar dropped 0.68 pct at 92.64 yen.
- Sterling rose 0.6 pct to \$1.6027.
- The dollar index was down 0.58 pct to 77.458.

CORPORATES: U.S. corporate bond spreads edged wider after a weak jobs report spurred angst about a recovery and investors sold bonds to lock in gains after this week's rally.

- The CDX.IG-13 index tightened by 1 bps to 78 bps.
- On the week, IG13 softened just over 8% while the HY13 ended net wider by 0.7bp at 100.53.
- S&P said global corporate defaults tallied 265 in full year 2009, marking the peak since the scorecard has been kept.

STOCKS: The Dow turned higher in late trading, led by technology shares and big manufacturers, while the Nasdaq was at session highs and the S&P 500 moved again into positive territory.

- Dow rose 0.11 pct to 10,618.19, S&P was up 0.29 pct to 1,144.98 and Nasdaq rose 0.74 pct to 2,317.17.
- S&P financials index was down 0.55 pct, S&P energy index rose 0.51 pct and S&P technology index gained 0.79 pct.
- KBW banks index dropped 0.19 pct.
- United Parcel's shares jumped 4.81 pct to \$60.17.
- Teva Pharmaceutical gained 4.4 pt to \$59.34 a day after company set a revenue target for 2015 of \$31 bln, more than double its current annual amount.

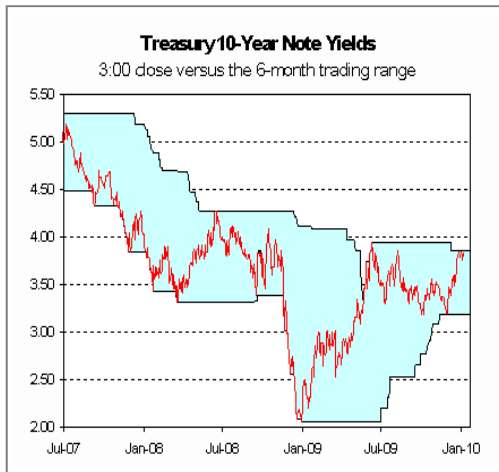
C & E: Oil rose as concerns about gasoline supplies following a Canadian refinery outage outweighed data showing an unexpected rise in U.S. job cuts.

- U.S. crude prices rose 0.29 pct to \$82.9 per barrel.
- Gold was up 0.42 pct to \$1,136.1 an ounce.
- Reuters-Jefferies index gained 0.08 pct to 290.77.

- 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	0.035	0.005	0.035	-0.004
3-Mo Bill	0.045	0.035	0.046	-0.002
6-Mo Bill	0.145	0.135	0.147	-0.014
1-Year	0.320	0.315	0.325	-0.042
2-Year	100.070	100.102	0.965	0.141
3-Year	98.859	98.891	1.526	0.180
5-Year	100.281	100.328	2.565	0.242
7-Year	99.656	99.703	3.306	0.195
10-Year	96.453	96.516	3.810	0.156
30-Year	94.875	94.953	4.696	-0.117

EQUITIES

	INDEX	CHANGE
DJIA	10578.59	-26.61
NASDAQ	2313.83	13.93
S&P 500	1141.34	-0.27

OIL

	PRICE	CHANGE
NYMEX	82.8	0.2
BRENT	81.5	0.0

EURODOLLAR FUTURES

	CLOSE	CHANGE
Jan-10	99.748	0.000
Mar-10	99.705	0.000
Jun-10	99.520	0.005
Sep-10	99.185	0.000

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.130	O/N	0.130
2-Week	0.150	2-Week	0.180
1-Month	0.170	1-Month	0.190
3-Month	0.200	3-Month	0.210
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.130	10:00 AM	0.060
2-Week	0.170	3:00 PM	0.055
1-Month	0.170		
3-Month	0.200		

IR SWAPS <19901>

	SPREAD		RATE	
2-Year	25.50	29.50	1.21	1.24
3-Year	35.25	39.25	1.86	1.88
5-Year	27.50	31.50	2.83	2.84
7-Year	11.00	15.00	3.41	3.40
10-Year	8.50	12.50	3.89	3.87
30-Year	-16.25	-12.25	4.53	4.51

FUTURES

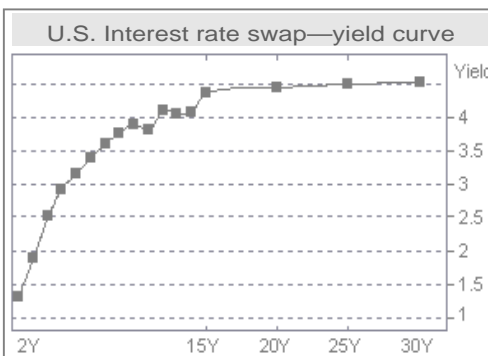
	PRICE	CHANGE
CBOT 5 yr	115.02	0.22
CBOT 10 yr	116.02	0.17
CBOT 30 yr	115.47	0.19

CURRENCIES

	BID	ASK
Euro	1.4412	1.4414
Sterling	1.6029	1.6034
JP Yen	92.65	92.68
Swiss Franc	1.0239	1.0242
Can Dollar	1.0317	1.0322
Mexico	12.6945	12.7006

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.110	0.130	-	-
1-Month	0.220	0.300	0.121	0.131
3-Month	0.240	0.450	0.138	0.148
6-Month	0.300	0.650	0.174	0.184
12-Month	0.850	1.250	0.375	0.385



FED FUNDS NYFRSM - 10AM

Open	0.1100	1m	0.2200
High	0.1200	3m	0.2544
Low	0.0600		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	13.5	12.5	1.11
3-Year	1.75	10/08/2012	-2	0	1.5
5-Year	2.875	09/02/2015	28	27	2.85
7-Year	5.125	18/10/2016	14	12	3.47
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	35	30	5.07

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	0	8	-
3-Year	1.375	09/01/2013	25.5	24.5	1.78
5-Year	2.625	20/11/2014	19	18	2.76
7-Year	5.25	15/09/2016	13	0	3.4
10-Year	3.75	27/03/2019	16	14	3.99
30-Year	6.25	15/07/2032	35	30	5.07

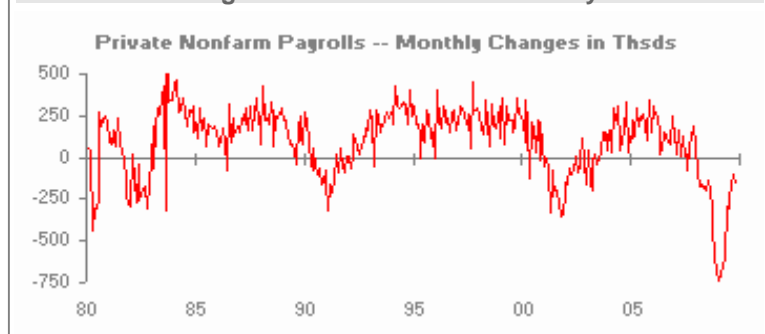
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	104.3010	105.0010	2.829
FHLMC	5.0	104.3010	105.0010	2.829

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.0010	105.0210	3.198
FHLMC	5.5	105.0410	105.0610	3.102
GNMA	5.5	105.0320	105.0520	3.750

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

U.S. employers slash jobs in Dec, pressuring Obama

U.S. employers cut 85,000 jobs in December, confounding expectations the labor market was finally stabilizing and piling pressure on President Barack Obama to spur job growth.

Unemployment, which held steady at 10 percent, remains the Achilles heel of the economy's recovery from its worst recession in 70 years. Creating jobs is critical to sustaining the recovery when government stimulus fades.

December's payrolls plunge was much worse than what economists had expected. Wall Street had forecast a flat reading and a tick up in the unemployment rate to 10.1 percent.

Payrolls fell in the manufacturing, construction and the service-providing sectors. Government employment also dipped.

In a separate report, the Commerce Department said wholesale inventories grew at the fastest rate in over five years in November and sales climbed strongly, implying businesses were preparing for a healthier economy.

The department's survey of households offered an even gloomier assessment of the job market, showing 661,000 people left the work force last month.

Separately, The ECRI's U.S. Future Inflation Gauge rose to 98.2 in December from 95.6 in November, which was revised slightly lower from 95.7.

U.S. lawmakers press for Geithner AIG testimony

Two prominent U.S. lawmakers called for U.S. Treasury Secretary Timothy Geithner to testify to help determine if the New York Federal Reserve Bank improperly influenced insurer AIG to withhold information on its payments to banks after a government bailout.

Representative Spencer Bachus, the top Republican on the House Financial Services Committee, and Elijah Cummings, a Democrat on the House Oversight and Government Reform Committee, requested their respective panels hold hearings on the matter.

The requests came after email traffic between lawyers for New York Fed and AIG released on Thursday showed the Fed sought to alter the disclosures in late 2008, when Geithner was still in charge of the bank.

Separately, U.S. House of Representatives Financial Services Committee Chairman Barney Frank said he has not yet decided whether to hold a hearing on the Fed's role in limiting American International Group disclosures on payments to banks after its bailout in late 2008.

UPS raises outlook, sets job cuts; shares jump

United Parcel Service Inc raised its fourth-quarter profit forecast but said it was cutting another 1,800 management and administrative jobs.

UPS shares rose as much as 6.5 percent to their highest level since the depths of the financial crisis in October 2008.

The shipper expects fourth-quarter earnings of 73 cents to 75 cents per share, up from an earlier estimate of 58 cents to 65 cents and besting Wall Street's view of a profit of 63 cents per share, according to Thomson Reuters I/B/E/S.

The higher forecast reflects improved shipping volume amid an economic recovery, while the elimination of 0.5 percent of the company's U.S. workforce of 340,000 is the result of increased automation of management functions, analysts said.

UPS said the cuts will come as it reorganizes its domestic small package division, which handles boxes of 150 pounds or less. It is cutting the number of regions to three from five and the number of districts to 20 from 46.

Two Fed officials say jobs key to exit strategy

Two Fed officials said they would like to see the U.S. jobs picture improve before the central bank withdraws its extraordinary support for the economy and markets.

The comments from Boston Federal Reserve Bank President Eric Rosengren and St. Louis Federal Reserve Bank President James Bullard came the same day government data showed U.S. employers unexpectedly cut 85,000 jobs in December. The December unemployment rate was unchanged at 10 percent.

Rosengren told a business conference in Hartford, Connecticut, that he expects the labor market will improve only slowly, with the unemployment rate likely remaining "quite elevated" in the early phases of the recovery. He said that with the economy still weak and the unemployment rate high, the Fed's accommodative policy stance is appropriate.

Rosengren was fairly pessimistic on the recovery's prospects. He said that while inventory rebuilding will likely "provide some spark, the strength of underlying demand as government stimulus subsidies is an open question."

He pointed to the high unemployment rate, as well as cautious consumers and businesses and continued banking strains, as significant economic headwinds. These headwinds mean the Fed should be in no rush to tighten policy, Rosengren said.

Bullard agreed that price pressures remain subdued. However, he cautioned that uncertainty about inflation was mounting in the United States.

Obama awards \$2.3 bln clean energy tax credits

U.S. President Barack Obama will unveil a \$2.3 billion tax credit to boost jobs by promoting clean energy, as fresh data showed that the country's unemployment remains stuck in the double digits.

The White House said the credit, from funds already earmarked under a \$787 billion stimulus package Obama signed last February, would create 17,000 new U.S. jobs and would be matched by an additional \$5 billion in private capital.

High unemployment is one Obama's most pressing domestic challenges and a monthly payroll report released served as a reminder that labor market conditions remain grim. U.S. unemployment was unchanged at 10 percent in December, while businesses unexpectedly shed 85,000 jobs.

The clean energy tax credits have been granted to 183 projects around the country involved in technologies that include solar, wind, efficiency and energy management projects.

In addition, the House of Representatives has approved an additional \$155 billion jobs package to boost hiring, although the Senate has yet to take up its version of this legislation and will first tackle Obama's signature healthcare reforms.

Euro zone jobless jump, Q3 GDP may spell momentum loss

Euro zone unemployment jumped to an 11-year high in November, data showed, and is likely to rise more next year in what could add to the instability of economic recovery now based on fickle inventory rebuilding and exports.

Eurostat said the number of people without jobs rose by 102,000 in November to 15.712 million, or 10 percent of the workforce in the 16 countries using the euro -- the highest since August 1998.

Net trade added less than previously estimated -- 0.1 percentage point, rather than 0.2 percentage point.

Investment, which accounts for almost one fifth of the euro zone's gross domestic product turned out weaker than expected and subtracted 0.2 percentage point rather than the previously



TODAY'S TOP NEWS

reported -0.1 point.

Finally household demand, which at 57 percent of the total is the biggest item in euro zone GDP, subtracted 0.1 percentage point from the final quarter-on-quarter figure although it was offset by government spending, which added 0.1 point.

New Japan finmin backtracks on yen after PM rebuke

Japan's new finance minister backed off his call for a weaker yen following an apparent rebuke from the prime minister, saying currency levels should be determined by markets.

Still, Naoto Kan said the government should pay heed to the views of the country's business community, signaling that he was sticking to the view of favoring a weaker yen to boost the competitiveness of Japanese exports.

The comment stirred speculation he would be more inclined to support official intervention -- last seen in 2004 -- if the currency is deemed too high. He said many Japanese firms were in favor of having the dollar move around 95 yen. That contrasted with Fujii, who had indicated he favored a strong yen.

It is extremely rare for a finance minister to refer to specific exchange rate levels and Kan's comments earned a rebuke from Prime Minister Yukio Hatoyama, who said on Friday the government should not comment on currency rates.

Foreign trade buoys German economy in November

German exports rose for the third month running in November, giving a boost to economic growth in the fourth quarter, but a drop in imports underlined weakening domestic demand in Europe's largest economy.

Exports rose by 1.6 percent on the month, preliminary Federal Statistics Office figures showed, outpacing the consensus forecast for an 0.5-percent increase.

Adjusted for seasonal swings, exports were 17.2 billion euros (\$24.7 billion) higher than imports, making the trade surplus the highest since June 2008. But the main contributor to the surplus was a 5.9-percent drop in imports.

In a separate report by the Economy Ministry, German industrial output posted a muted rise in November but easing demand is likely to dampen a recovery in production in the coming months.

The seasonally adjusted month-on-month rise of 0.7 percent compared with the mid-range forecast in a Reuters poll of 30 economists for output to rise by 1.0 percent.

UK factory gate inflation gathers pace in December

British factory gate inflation rose more than expected in December and at its fastest annual rate in nearly a year, official data showed.

The Office for National Statistics said producer output price inflation was 3.5 percent higher last month than a year ago, beating the consensus forecast for a 3.1 percent rise.

Input price inflation also picked up more than expected, by 6.9 percent, its fastest annual rate since November 2008.

The increase was driven by a two-thirds rise in crude oil prices over the year.

There was little market reaction to the data, which suggested sterling's weakness was continuing to push up the price of imported raw materials.

Separately, British commercial property values rose 3.3 percent in December, their largest monthly gain since records began nine years ago and the sixth consecutive monthly hike, the latest CB Richard Ellis Monthly Index found.

Canada jobs recovery stalls in December

The recovery in Canada's job market stalled in December as employers unexpectedly cut 2,600 jobs after hefty hiring in November, another sign the economic revival will be sluggish rather than in leaps and bounds.

The data released by Statistics Canada showed the unemployment rate remained unchanged at 8.5 percent, as forecast in a Reuters poll.

The job losses, which followed a 79,000-job gain in November, are small enough to be considered a flat reading but disappointed the market consensus of a 20,000 increase.

The Bank of Canada is likely to shrug off the worse-than-expected numbers when it sets interest rates on Jan. 19. It is widely expected to keep its benchmark interest rate at an all-time low of 0.25 percent until mid-year.

NEXT UP

Most primary dealers see Fed rate hike in 2010

The Fed will likely raise interest rates starting in 2010, according to a poll of the big banks that deal directly with the central bank, even after worse-than-expected payrolls data for December dented hopes for a swift recovery in the labor market.

In a Reuters poll taken after Friday's nonfarm payrolls report, and in which 16 of the 18 primary dealers responded, most left their expectations for the Fed's first rate hike unchanged from the previous poll on December 16. On average, dealers saw the unemployment rate peaking at 10.3 percent. Most thought the peak would be reached by July 2010. The median forecast for the unemployment peak was 10.2 percent.

All but three of the 16 primary dealers who responded to poll said they still expected the Fed to end its MBS purchase program in March rather than extending its duration a second time. Dealers also weighed in on future Treasury yields. As the first rate hike draws nearer, yields on Treasury securities are expected to head higher--especially for longer-dated notes and bonds. The primary dealers polled offered predictions for the yield on the 10-year Treasury note at the end of 2010, with a forecast average of 4.24 percent and a median of 4.35 percent.

German 2009 GDP seen contracting 4.8 percent y/y

GDP should post a 4.8 percent fall for 2009 compared to the previous year, a Reuters poll of economists showed.

The mid-range forecast in a Reuters survey of 31 economists was a tad brighter than that made an October survey, which expected GDP to contract by 5 percent for the year. Forecasts for the decline ranged between 4.2 and 5 percent.

"Consumption was likely a drag -- Germany is back where it was before, an export-dependent economy," said ING Financial Markets' Carsten Brzeski, who forecast a more modest 4.7 percent contraction for 2009.

Data showed exports rose for the third month running in November, giving a boost to economic growth in the fourth quarter, but a drop in imports underlined weakening domestic demand.

The German economy is heavily dependent on exports for growth, and manufacturing orders data on Thursday gave a jolt to the outlook for 2010, showing a gain of just 0.2 percent on the month as weak foreign demand sapped new business.



DEEP DIVE Commentary and Analysis

It takes a crisis to raise a mortgage program

By Pedro Nicolaci da Costa

April Fools' Day will have a special meaning for the Federal Reserve this year: it will be the first day the central bank allows a ravaged U.S. mortgage market to stand on its own two feet.

Even if things are a bit wobbly at first, the Fed is unlikely to step in again after its debt purchase program -- devised at the height of the financial meltdown -- expires. That would take a renewed crisis, like a sudden and destabilizing spike in mortgage rates.

Not that such a possibility is out of the question. Some November data, such as housing starts and pending home sales -- homes are under contract to be sold -- showed abrupt retrenchments after signs of improvement, suggesting government tax credits and the Fed's loan purchases were playing a big part in propping up the market.

Barring a double-dip in housing, however, Fed officials are unlikely to meddle.

Their reluctance to intervene anew has many roots. For one thing, it would signal a policy about-face that could adversely affect markets as investors reassess what they believed was an improving economic outlook.

More importantly, it is unclear how much more impact the Fed could have on a market where it has already become by far the overwhelming source of demand.

Minutes of the Fed's December meeting showed a few members of the central bank's policy committee thought additional mortgage buying might be desirable under more adverse conditions.

Yet in the policy statement issued after the meeting, the central bank reiterated plans to shutter the program by the end of March and said it was proceeding to close down other emergency lending facilities on schedule.

"That was a fairly strong signal that they will not continue the purchases later on," said Torsten Slok, senior economist at Deutsche Bank.

Market analysts say a rapid spike in mortgage rates above 6 percent, up from current levels just above 5 percent, could get the Fed to rethink its stance, particularly if a spike is accompanied by a downturn in sales or prices.

Fed officials are hopeful, though, that their exit from the mortgage market will have much less impact.

A HIGH BAR

Besides home loan rates, there are other impediments to a fresh round of mortgage-backed debt purchases, including the Fed's desire to keep inflation expectations under control.

One of the reasons the Fed capped its bond-buying program, which included more than \$1.4 trillion in mortgage-related securities and \$300 billion in Treasury debt, was the perception that the central bank was "monetizing" federal deficits -- printing money to keep the government solvent.

This latent fear, prevalent in financial markets and reflected in the elevated price of gold, has the potential to turn more than \$1 trillion in dormant excess bank reserves into a runaway rise in prices, analysts say.

Fed officials admit that such a prospect has given them a fresh perspective on the limits of monetary policy, leaving them little appetite for testing the market's boundaries.

If inflation expectations were to become unhinged, there could be a steep sell-off in the U.S. government bond market, pushing borrowing costs higher and potentially derailing what many still consider a fragile recovery.

Policy makers stress that, in a moment of extreme uncertainty, wiggle room is a huge asset, which helps explain why they want to keep all options on the table.

"We are still in uncharted waters," Fed Vice Chairman Donald Kohn said in a speech over the weekend. "We will need to be flexible and adjust as we gain experience."

But recent remarks from Fed officials indicate that they would like to move as quickly as possible toward a state of affairs where they can rely less heavily on unconventional policy measures.

Kansas City Federal Reserve Bank President Thomas Hoenig, one of the central bank's more hawkish members, stressed on Thursday that he would like to see policy tightened sooner rather than later.

"They're kind of in a no-man's land -- never been here before, not sure what the street signs are, where the road bends," said Andrew Brenner, managing director at Guggenheim Partners. "But they're at the point where they would like to start reducing the balance sheet."

That's market parlance for the Fed's outstanding credit to the banking system, which has more than doubled to some \$2.2 trillion. As long as banks are reluctant to lend, this supply of funds has little bearing on inflation. But if the flood gates were to open too quickly, the consequences could be serious.

More mortgage buying would likely push the market closer in that direction, making the Fed's already difficult exit strategy all the more complicated.

Yen reclaiming carry trade as U.S. bond yields rise

By Gertrude Chavez-Dreyfuss

The yen, which had been toppled by the dollar last year as investors' top choice to fund carry trades, looks set to reclaim the throne in 2010.

The recent spike in U.S. bond yields, coinciding with a rally in the dollar against the yen, is flagging a return to the yen to fund carry trades -- the risky strategy of using a low-yielding currency to purchase assets in higher-yielding currencies in the search for better returns.

The rise in U.S. bond yields is making the cost of carry in the dollar more expensive, which should prompt investors to use the yen -- offering lower rates and less volatility -- to wade back into speculative assets.

"I think the yen will reclaim its status as the funding currency of choice in 2010. Even if the Federal Reserve raises rates by 25-50 basis points, that would mean U.S. rates will still be markedly above Japan's," said Richard Franulovich, senior currency strategist at Westpac in New York.

The yen, with its near-zero percent interest rates, was the preferred funding currency for more than seven years. That changed in the summer of 2009 when the cost of benchmark three-month interbank dollar funds fell below that of the yen.

As carry trades depend both on low interest rates and low volatility, the rise in U.S. yields has boosted uncertainty in that market. At the start of December, the credit market started to advance the expected timing of a U.S. interest-rate increase, which caused rate differentials to move in favor of the United States versus Japan.

Although financial markets on Friday pared back U.S. rate hike expectations following an unexpectedly weak U.S. non-farm payrolls report for December, the jobs data did not shake overall optimism about the U.S. economy.

In contrast, "deflation remains a major concern in Japan and this means monetary policy will remain on hold and Japanese interest rates will remain at extremely low levels," said Jonathan Clark, deputy chief investment officer at FX Concepts, a \$12 billion currency hedge fund in New York.



DEEP DIVE Commentary and Analysis

BACK-UP IN U.S. YIELDS

The dollar/yen pair has become more sensitive to movements in bond yields because the currencies are competing as the markets' favored funding unit. Any shift in the yield curve or rate expectations has an impact on both currencies.

Over the past month, U.S. 10-year bond yields rose from 3.2 percent to 3.92 percent by end-December. The rise in yields has underpinned the dollar, which has surged about 9 percent against the yen since late November.

That was driven mainly by implied inflation expectations, analysts said, and rising spreads in credit default swaps, which suggest nervousness in financial markets has eased and risk appetite has increased.

Short-term U.S. interest rates are likely to remain low. That should leave the market dealing with an extremely steep yield curve, which is attractive to buyers of debt. The difference between the U.S. two-year and 10-year yields was near a record on Friday, at about 286 basis points.

The 25-day correlation between dollar/yen and benchmark U.S. yields was still at a robust 92 percent on Friday, according to Reuters data. It was as high as 94 percent toward the end of last year.

On a 90-day rolling basis, the correlation showed a rising trend.

JAPAN'S "LIFERS"

The steeper yield curve in the United States should encourage Japan's life insurance companies, massive but conservative overseas investors known as "lifers," to buy the greenback against the yen. Lifers invest heavily in the U.S. Treasury market.

Sebastian Galy, senior currency strategist at BNP Paribas in New York, said the life insurance companies need to have profitable portfolios, adding that their threshold level in yields is around 2 percent.

"When they see that the U.S. yield curve is steepening like this...they buy into it, meaning they buy more dollars via U.S. Treasuries because they want to grab yield," he said.

Galy said most Treasury purchases are underhedged, meaning there is no corresponding yen purchase to offset the dollar buying. That suggests these lifers expect the yen to weaken further and the dollar to gain some more, a view shared by most market participants.

On Friday, the yen fell to its lowest against the dollar since August. Some investors believe the yen has begun a sustained downtrend that could last into the middle of 2010.

Westpac's Franulovich expects dollar/yen to hit 95 in three months and 100 in six months.

INSIDE DEBT is produced by Reuters in partnership with ICAP.

(Compiled by Anil Kumar and Rahul Karunakar in Bangalore)

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