

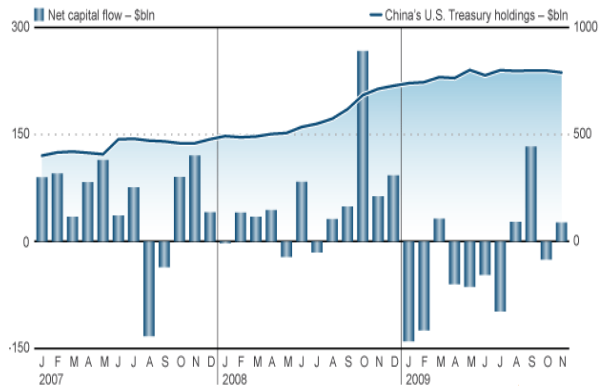
# INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Tuesday, January 19, 2010

## CHART OF THE DAY

### U.S. capital inflows



Foreign investors' appetite for U.S. securities rebounded in November, led by heavy demand for long-term Treasuries as optimism grew about the prospects of a U.S. economic recovery.

## TODAY'S TOP NEWS

- Turnout heavy in crucial Massachusetts Senate poll
- Bernanke seeks govt audit of Fed's AIG bailout
- Kraft snares Cadbury for \$19.6 billion
- U.S. inflows rebounds in Nov; China decreases Trys
- Citigroup Q4 loss narrows, loans seem to stabilize
- U.S. homebuilder sentiment falls again in January
- UK inflation surges at record pace in December
- German FinMin upbeat on banks sharing bailout costs

## ECON WATCH

FOR WEDNESDAY JANUARY 20

ET	Indicators	Unit	Reuters	Prior
02:00	DE Producer prices mm	%	0.2	0.1
02:00	DE Producer prices yy	%	-5.1	-5.9
04:30	GB Claimant count	k	-2.5	-6.3
04:30	GB ILO unemployment rate	%	8.0	7.9
04:30	GB Average earnings	%	1.6	1.5
07:00	US Mortgage index	ind	-	528.1
07:00	US Mortgage refi index	ind	-	2407.2
07:00	CA CPI mm	%	-0.2	0.5
07:00	CA CPI yy	%	1.5	1.0
07:00	CA CPI BoC Core mm	%	-0.2	0.4
08:30	US Producer prices mm	%	0.0	1.8
08:30	US Producer prices yy	%	4.5	2.4
08:30	US Ex-Food / Energy mm	%	0.1	0.5
08:30	US Ex-Food / Energy yy	%	1.0	1.2
08:30	US Housing Starts	mln	0.58	0.574
08:30	US Building permits	mln	0.59	0.589

## MARKETS TODAY

**TODAY'S TOP STORY:** Massachusetts voters streamed to the polls in large numbers in a cliffhanger election for a new U.S. senator that could derail Democrats' dominance in Washington and scuttle President Barack Obama's top priority of sweeping healthcare reform.  
**For more please click here**

**TREASURIES:** U.S. Treasury debt prices were slightly lower as stocks rose on investor hopes that a Republican could win the U.S. Senate special election being held in Massachusetts, an outcome seen as benefiting U.S. companies.

- 30-yr bond prices shed 7/32, lifting its yield to 4.60 pct on Friday.
- 10-yr Treasury price was down 7/32 yielding 3.71 pct from 3.68 pct.
- 2-yr notes fell 2/32 to yield 0.89 pct, up from 0.87 pct.

**FOREX:** The euro fell broadly as German investor sentiment soured while worries about Greece's finances stoked concerns that swelling deficits in the Euro zone's weaker members will keep pressure on the currency.

- The euro fell 0.55 pct at \$1.4301. Sterling rose 0.28 pct at \$1.6376.
- Dollar gained 0.43 pct at 91.12 yen, well off an earlier four-week low of 90.32.
- The dollar index was up 0.5 pct at 77.451.

**CORPORATES:** U.S. corporate bond prices fell after Citigroup Inc posted a fourth-quarter loss, raising concerns that the corporate earnings season is turning out to be weaker than expected.

- The CDX.IG-13 index widened by 4 bps to 84 bps.
- Five-year CDS on Cadbury tightened by around 24 bps to 51 bps.
- Spreads on Citi's 8.5 pct bonds due in 2019 widened 8 bps to 243 bps over comparable Treasuries.
- Kraft's 6.125 pct notes due in 2018 fell to about 107 cents on the news, pushing spreads 2 bps wider to 132 bps.

**STOCKS:** U.S. stocks rose broadly as investors scooped up healthcare shares on bets that a potential Republican victory in Massachusetts' Senate race could stall U.S. President Barack Obama's reforms and remove a threat to profits in the sector.

- Dow rose 1.09 pct to 10,725.43, S&P was up 1.25 pct to 1,150.23 and Nasdaq gained 1.42 pct to 2,320.40.
- The S&P Healthcare Index climbed 2.04 pct, including drug company Eli Lilly, which rose 4.44 pct.
- Health insurers Humana Inc rose 7.07 pct to \$51.94 and Aetna Inc gained nearly 4.15 pct to \$32.66.
- Kraft Foods Inc fell 0.57 pct to \$29.41.
- S&P technology index rose 1.57 pct, S&P auto index rose 1.46 pct.

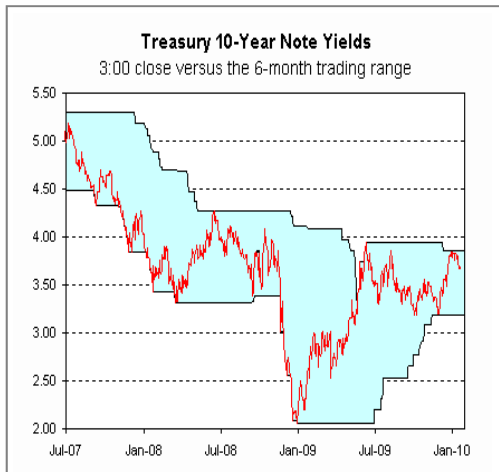
**C & E:** Oil rose after five sessions of losses as gains in the U.S. stock market boosted prices, outweighing earlier pressure from mild weather and the stronger greenback.

- U.S. crude prices jumped 1.31 pct to \$79.02 per barrel.
- Gold gained 0.49 pct to \$1,138.0 an ounce.
- Reuters-Jefferies index was up 0.65 pct to 283.25.

- 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	0.040	0.005	0.041	0.001
3-Mo Bill	0.060	0.040	0.061	-0.007
6-Mo Bill	0.140	0.130	0.142	-0.006
1-Year	0.315	0.310	0.320	-
2-Year	100.195	100.219	0.899	-0.043
3-Year	99.719	99.750	1.472	-0.086
5-Year	100.766	100.813	2.460	-0.176
7-Year	100.375	100.422	3.189	-0.156
10-Year	97.281	97.344	3.707	-0.172
30-Year	96.406	96.484	4.597	-0.195

**EQUITIES**

	INDEX	CHANGE
DJIA	10713.42	103.77
NASDAQ	2317.09	29.10
S&P 500	1148.07	12.00

**OIL**

	PRICE	CHANGE
NYMEX	79.0	1.0
BRENT	77.7	0.6

**EURODOLLAR FUTURES**

	CLOSE	CHANGE
Feb-10	99.738	0.008
Mar-10	99.715	0.000
Jun-10	99.575	-0.005
Sep-10	99.275	-0.015

**REPURCHASE AGREEMENTS**

G/C		MORTGAGE REPOS	
O/N	0.230	O/N	0.210
2-Week	0.190	2-Week	0.230
1-Month	0.200	1-Month	0.230
3-Month	0.250	3-Month	0.300
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX	
O/N	0.210	10:00 AM	0.150
2-Week	0.210	3:00 PM	0.144
1-Month	0.210		
3-Month	0.280		

**IR SWAPS <19901>**

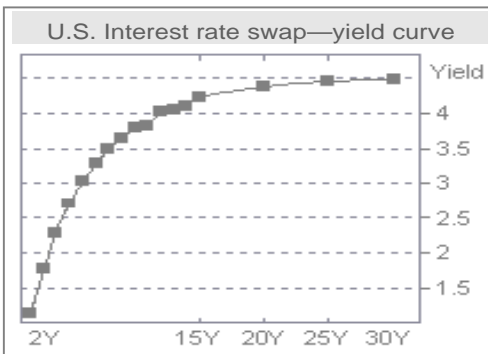
	SPREAD		RATE	
2-Year	24.50	28.50	1.14	1.17
3-Year	30.00	34.00	1.77	1.78
5-Year	26.75	30.75	2.72	2.73
7-Year	11.50	15.50	3.30	3.30
10-Year	8.50	12.50	3.78	3.77
30-Year	-12.25	-8.25	4.47	4.45

**FUTURES**

	PRICE	CHANGE
CBOT 5 yr	115.57	-0.16
CBOT 10 yr	117.09	-0.19
CBOT 30 yr	117.22	-0.16

**EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)**

	BID	ASK	BID	ASK
O/N	0.120	0.160	-	-
1-Month	0.220	0.300	0.124	0.134
3-Month	0.240	0.450	0.137	0.147
6-Month	0.300	0.550	0.152	0.162
12-Month	0.800	1.150	0.345	0.355



**CURRENCIES**

	BID	ASK
Euro	1.4294	1.4296
Sterling	1.6364	1.6370
JP Yen	91.09	91.12
Swiss Franc	1.0323	1.0326
Can Dollar	1.0309	1.0316
Mexico	12.6573	12.6678

**FED FUNDS NYFR<sup>SM</sup> - 10AM**

Open	0.1100	1m	0.2237
High	0.1400	3m	0.2481
Low	0.0800		

**ACTIVE FANNIE MAE AGENCIES**

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	0.875	12/01/2012	14 13	1.04
3-Year	1.375	09/01/2013	23 22.5	1.71
5-Year	2.875	09/02/2015	31.5 31	2.78
7-Year	5.125	18/10/2016	15 14.5	3.34
10-Year	-	-	- -	-
30-Year	6.625	15/11/2030	36 32.5	4.96

**ACTIVE FREDDIE MAC AGENCIES**

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1.125	15/12/2011	12 0	1.02
3-Year	1.75	22/02/2013	31 29	1.78
5-Year	2.625	20/11/2014	21 0	2.67
7-Year	5.25	15/09/2016	14.75 14	3.34
10-Year	3.75	27/03/2019	19.5 17.5	3.91
30-Year	6.25	15/07/2032	35.25 34.75	4.95

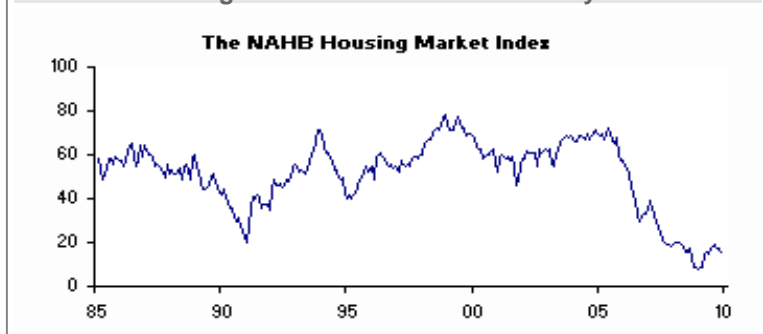
**Active MBS 15YR**

	CPN	BID	ASK	YIELD
FNMA	5.0	105.0800	105.1000	2.690
FHLMC	5.0	105.0800	105.1000	2.690

**Active MBS 30YR**

	CPN	BID	ASK	YIELD
FNMA	5.5	105.1400	105.1600	3.008
FHLMC	5.5	105.1800	105.2000	2.900
GNMA	5.5	105.1600	105.1800	3.625

**Wrightson ICAP<sup>SM</sup> Chart of the Day**



## TODAY'S TOP NEWS

**Turnout heavy in crucial Massachusetts Senate poll**

Massachusetts voters streamed to the polls in large numbers in a cliffhanger election for a new U.S. senator that could derail Democrats' dominance in Washington and scuttle President Barack Obama's top priority of sweeping healthcare reform.

What looked likely weeks ago to be a Democratic shoo-in to replace late party icon Edward Kennedy has turned into a desperate effort by Democrats after a last-minute surge by the likable Republican, state Senator Scott Brown.

Latest opinion polls suggest Brown could defeat state Attorney General Martha Coakley, and take away the Democrats' 60-vote supermajority in Congress, which enables them to overcome Republican procedural roadblocks.

In Washington, Obama spokesman Robert Gibbs said the president does not believe healthcare reform will fail if Coakley loses. But Obama is "both surprised and frustrated" and "not pleased" by the closeness of the Massachusetts race, Gibbs said.

Turnout is often low in off-season elections, but given intense interest in the current race, Secretary of State William Galvin said he was bracing for voting levels similar to that of a regular state election. High turnout could benefit the more energized Brown campaign.

**Kraft snares Cadbury for \$19.6 billion**

Kraft Foods sealed a friendly deal to buy British candy maker Cadbury for about \$19.6 billion (11.9 billion pounds) after frantic last-minute talks broke an impasse over price.

Kraft Chief Executive Officer Irene Rosenfeld had to inject more cash into her bid and drop the number of new shares in the offer to win over Cadbury Chairman Roger Carr and mollify billionaire investor Warren Buffett, the U.S. food company's top shareholder.

The deal would create the world's biggest confectioner, and analysts see little likelihood of a counterbid.

The cash-and-stock agreement, which dealmakers said was struck after all-night negotiations at the London headquarters of investment bank Lazard, values each Cadbury share at 840 pence. Shareholders are also set to get a 10p special dividend, bringing it to a total of 850p.

The combined company will just overtake privately owned Mars-Wrigley as the world's top sweet maker, bringing under one roof Cadbury's Dairy Milk chocolate and Trident gum and Kraft's Milka, Toblerone and Terry's chocolate brands.

**Citigroup Q4 loss narrows, loans seem to stabilize**

Citigroup Inc posted a \$7.6 billion quarterly loss on costs related to repayment of U.S. bailout funds and still-high loan losses, but the bank's shares edged higher as some investors saw glimmers of hope.

The government still has a bigger stake in Citigroup than in any other major U.S. bank, reflecting the swamp of toxic assets that threatened Citi's survival.

Chief Executive Vikram Pandit told investors that U.S. consumer credit remained an issue for the bank, although he said some credit fundamentals appeared to be stabilizing, especially internationally. The third-largest U.S. bank said its quarterly loss amounted to 33 cents a share, compared with a loss of \$17.3 billion, or \$3.40 a share, a year earlier.

On a conference call with reporters, Chief Financial Officer John Gerspach said Citi saw most parts of its corporate credit portfolio stabilize in the fourth quarter.

Gerspach said investment banking businesses, including merger advisory, will continue to be a focus for the bank.

**Bernanke seeks govt audit of Fed's AIG bailout**

U.S. Federal Reserve chairman Ben Bernanke asked a government auditor to review the Fed's actions in bailing out AIG in 2008, as controversy persisted over the central bank's role in extending billions in credit to the insurer.

Bernanke, in a letter to Acting Comptroller General Gene Dodaro, said the Fed would make available to the Government Accountability Office all documents and personnel necessary to conduct the review.

Bernanke's request comes as the U.S. House of Representatives Oversight and Government Reform Committee is gearing up for a hearing next week into whether the NY Fed improperly limited public disclosures about payments to banks to unwind \$62.1 billion in credit default swaps. Bernanke added that the Fed loan facility was fully secured and should be fully repaid by Sept. 16, 2013, five years after it was granted.

Separately, U.S. Senate may vote as early as Friday to confirm Ben Bernanke to a second term as chairman of the Federal Reserve, a senior Democratic party aide said.

The aide said no decision had been made, but Friday is a possible date and Senate Democrats want to move on the nomination as soon as possible.

**U.S. inflows rebounds in Nov; China decreases Trys**

Foreign demand for U.S. securities rebounded in November, the Treasury Department said, as investors grew more optimistic about the long-term prospects of the U.S. economy.

Net overall capital inflows into the United States rebounded to \$26.6 billion in November from a revised outflow of \$25.4 billion the previous month. Excluding swaps, net long-term capital inflows jumped to \$126.8 billion in November from a revised \$19.3 billion inflow in the previous month.

China decreased its holdings of U.S. government bonds to \$789.6 billion in November. In October, it held \$798.9 billion.

Japan, however, boosted its Treasury investments to \$757.3 billion from \$745.9 billion while UK's holdings of U.S. government bonds increased to \$277.5 billion from \$230.1 billion.

Net private purchases of Treasury bonds and notes hit a record of \$87.1 billion in November.

Overall, foreign private investors bought a net \$26.8 billion of U.S. assets in November, reversing an outflow of \$43.6 billion in the previous month.

**U.S. homebuilder sentiment falls again in January**

U.S. home builder sentiment unexpectedly fell in January to the lowest level since June on concerns over the weak labor market and high foreclosure volume, according to a survey.

The drop in the NAHB/Wells Fargo Housing Market Index pointed to a patchy recovery in the housing sector.

The index slipped to 15 in January from 16 last month, below market expectations for a reading of 17.

The drop in homebuilder sentiment follows data earlier this month from the National Association of Realtors showing previously-owned U.S. homes under contract to be sold fell more sharply than expected in November. Housing is slowly healing after a three-year slump. The homebuilder sentiment index is up sharply from the 8 reading in January 2009. The NAHB survey showed the current sales conditions gauge for single-family home sales dipped one point to 15 this month. The sales expectations measure for the next six months remained steady at 26.

The traffic of prospective buyers index fell one point to 12 after remaining at 13 for three straight months. Sentiment fell in all four U.S. regions.



## TODAY'S TOP NEWS

**UK inflation surges at record pace in December**

Britain's inflation accelerated in December at a record pace, prompting worries that interest rates might rise sooner than expected, though the surge was largely due to an unflattering comparison with a year earlier.

Consumer prices rose at a year-on-year rate of 2.9 percent in December -- a nine-month high -- and a full percentage point faster than the 1.9 percent recorded in November, the biggest month-to-month jump since records started in January 1997.

The longer-running retail price index rose to 2.4 percent from 0.3 percent, the highest since November 2008 and the biggest monthly increase in the annual rate since 1979.

Separately, Global real exchange rates need to change to reduce trade imbalances, or the world risks a repeat of the recent financial crisis, BoE Governor Mervyn King said.

King said that countries' trade surpluses and deficits were starting to rise again as the world economy recovered from the financial crisis, increasing potentially damaging flows of capital from exporters, like China, to importers.

**German FinMin upbeat on banks sharing bailout costs**

German Finance Minister Wolfgang Schaeuble said he saw growing signs of achieving an international agreement on measures for the banking sector to share the costs of funding bailouts.

He noted that Germany has pushed for a financial transaction tax, and that the G20 had instructed the IMF to determine ways the financial services industry could help pay for the cost of bailing it out when problems strike.

Meanwhile, German analyst and investor sentiment fell more than expected in January. The Mannheim-based ZEW economic think tank said its monthly poll of economic sentiment fell for a fourth consecutive month to 47.2 from 50.4 in December, undershooting the consensus forecast for a reading of 49.5.

Separately, the German government sees exports rising 5.1 percent in 2010 and supporting a modest recovery in Europe's largest economy. Imports will also rise, by 3.4 percent, but private consumption will weigh on growth, falling 0.5 percent.

**Japan PM: To work with BOJ to beat deflation**

Japanese Prime Minister Yukio Hatoyama said that the government will work closely with the BOJ to help the economy overcome deflation.

"We must guide economic policy together with the BOJ" to combat deflation, Hatoyama told the lower house of parliament.

He also vowed to do his utmost to prop up the economy by boosting demand and creating new job opportunities.

In a separate report, Japanese consumer confidence deteriorated for the second straight month in December.

The survey's sentiment index was 37.6, down from 39.5 in November.

Separately, Japan Airlines Corp filed for bankruptcy protection owing more than \$25 billion, and vowed to slash 15,700 jobs and unprofitable routes as it tries to survive volatile fuel costs and fickle flyers.

JAL will remain in the skies thanks to nearly 1 trillion yen (\$11 billion) in state-backed support and faces a sweeping restructuring under a new board and management.

**China, Taiwan keep tightening, fearing asset bubbles**

The central banks of China and Taiwan tightened policy to drain money from the banking system, marking intensified efforts in the region to head off inflation and cool asset bubbles.

A week after raising bank reserve ratio requirements for the first time since June 2008, the PBOC lifted the auction yield on one-year bills in its regular open market operation for a second week in a row, and by more than expected.

Taiwan also nudged up its overnight lending rate, the rate at which banks borrow and lend to each other, by one basis point to an eight-month high.

Most economists expect the central bank to hold fire on raising benchmark deposit and lending rates until around the middle of the year.

However, analysts said China has started tightening its grip on liquidity sooner than expected in a sign that Beijing was increasingly worried cheap cash could inflate property and share markets and stoke consumer inflation.

## NEXT UP

**Dec U.S. housing starts seen up, contained by weather**

The median forecast is for a rise of about 1 percent in U.S. housing starts to 580,000 annual units in December. Forecasts from 72 economists ranged from 490,000 to 630,000 annual units.

The median forecast is for a rise of about 0.2 percent for building permits to 590,000 annual units in December. Estimates from 51 economists ranged from 540,000 to 600,000 annual units. Home building and permits to build houses likely rose slightly in December but were constrained by unusually cold winter weather.

An extended and broadened home buyer tax credit has beefed up demand, helping reduce a massive oversupply of vacant homes on the market to stabilize housing after a three-year crash. Of concern is whether housing demand can be sustained as this incentive ends and as mortgage rates are seen climbing closer to 6 percent than 5 percent later this year.

Also a wild card is the pace at which banks sell the foreclosed properties they now carry. Most housing industry experts expect the pace will be gradual, to prevent a double-dip in housing, but any burst of foreclosure sales would derail a recovery.

**With tech salaries nearly flat, frustration rises**

U.S. technology professionals are more frustrated with their pay than they have been in years as their salaries stagnate, according to an annual survey of about 17,000 visitors to the Dice.com website.

Dice Holdings Inc's Dice.com found the average pay for U.S. tech jobs rose 1 percent last year to \$78,845, compared to a 4.6 percent pay increase the year before.

That modest pay increase is fueling dissatisfaction. Only 46 percent said they are satisfied with the pay, compared to at least 53 percent who said so in each of the previous three years. About half the workers say employers are doing nothing to keep them motivated, according to the survey, and more than three-quarters say they received no bonus in 2009. The results suggest employers may have trouble keeping technology staff, leading to a "retentionless recovery," said Tom Silver, Dice's senior vice president in North America. The survey also showed about 70 percent of respondents identified themselves as Caucasian, and about 7 percent each said they were either African American or Asian Indian. About 48 percent of the positions posted on the site are contractor jobs.



## DEEP DIVE Commentary and Analysis

**ANALYSIS-Obama shifts to populist tone on economy**

By Caren Bohan

A fiery, more populist rhetoric will mark President Barack Obama's economic message in 2010, as he puts job creation and a vow to take on special interests like Wall Street at the top of his agenda.

Obama moves into his second year in office grappling with a sharp drop in his popularity to roughly 50 percent compared to the 70-percent approval rating he enjoyed at his inauguration a year ago on Wednesday.

The high U.S. unemployment rate of 10 percent has stirred deep anxiety among voters at a time when Obama and his Democratic allies are gearing up for November congressional elections in which their majority status could be eroded.

When Obama outlines his priorities for the coming year in his State of the Union address to Congress on Jan. 27 and in his budget on Feb. 1, he is expected to discuss the need for long-term reduction in the federal budget deficit, which has ballooned to \$1.4 trillion during the recession.

But White House aides emphasized that job growth would be the top focus near term. Obama will also push vigorously for legislation on Capitol Hill to tighten financial regulation.

"If we, as a country, are not successful in establishing job growth and economic growth soundly, we will not achieve any of our objectives. We will not achieve a sustainable budget posture with unemployment in the high single digits," said top White House economic adviser Lawrence Summers.

"So priority Number One has to be assuring rapid job growth," said Summers, director of the National Economic Council.

Obama and leading Democrats are coalescing around a push for targeted proposals to spur job growth and a plan, unveiled by Obama, to slap a new tax on Wall Street banks. The House of Representatives last month passed a \$155 billion package aimed at spurring jobs growth through infrastructure projects and helping states pay the salaries of public employees.

The Senate is expected to take up its version of the legislation in coming weeks.

Unveiling his proposal for a tax of up to \$117 billion on the largest U.S. banks last week, Obama lambasted the bankers for having taken "reckless risks" that led to the 2008-2009 financial crisis and also took aim at their "massive profits and obscene bonuses." He demanded they reimburse taxpayers for their losses in the financial bailout.

**AMERICANS' ANGER AT WALL STREET**

Obama, who has called the bankers "fat cats," is tapping into anger among Americans at big Wall Street compensation packages in the wake of the crisis.

His criticisms also harken back to a 2008 campaign theme of promising to take on special interests. Obama took heat from some Democratic supporters last year who said his proposals for regulatory reform were not tough enough on Wall Street.

Political analysts say Obama is sure to hit these populist themes hard as he seeks to push back at Republicans who have gained political traction by attacking the president's proposed health care plan as a costly intrusion into the economy.

The White House credits its \$787 billion stimulus package with rescuing the economy from what could have been another Great Depression. But Republicans point to the unemployment rate to argue the stimulus was wasteful and ineffective.

"(Obama) is up against very determined opposition across the board on a number of issues that has dented him in the polls," said Bruce Buchanan, a political scientist at the University of Texas, Austin. "What he needs to do is mobilize some support and appeal to people who have been driven away by opposition

attacks on things like healthcare."

Buchanan said that Obama, known for his calm demeanor, could benefit from trying to "gin up a little bit of that emotional support" by attacking Wall Street.

"It is probably the best card they have, to revert to populism," said Terry Madonna, a professor of public affairs at Franklin and Marshall College in Lancaster, Pennsylvania.

But Madonna said that the sharp change in Obama's political fortunes compared to a year ago will be hard to reverse and he cited the tight race in Tuesday's special election to replace the late Senator Edward Kennedy in Massachusetts as boding poorly for Democrats.

Republican contender Scott Brown is polling evenly or slightly ahead of Democrat Martha Coakley. This has surprised pundits because Massachusetts is one of the most reliably liberal states in the country.

Madonna said Obama had erred in deciding to push ambitious proposals for healthcare reform and caps on greenhouse gas emissions, which he said shifted the focus from the economy.

But both Buchanan and Mark Zandi, chief economist at Moody's Economy.com, said Obama deserved a grade of at least a B for his handling of the economy.

"He's done roughly the right things and I think we'll get proof of that over the course of the next year," said Zandi, who advised Obama's opponent, Republican John McCain, during the 2008 election, and has advised the Obama administration.

"The stimulus package was reasonably well designed and put together and most importantly, it was done quickly enough to make a difference," Zandi said.

He predicted that job growth would return by spring, helped initially by government hiring for the Census, with private-sector hiring kicking in by June.

**COLUMN-Yuan policy seen hostage to U.S., China fortunes**

By Neal Kimberley

Market expectations of a firming yuan over the next year may be misplaced as the Chinese and U.S. governments grapple with economic and political challenges.

The dollar/yuan non-deliverable forward market implies a 12-month yuan appreciation of some 3.31 percent, but this may prove to be unrealistic.

The United States has long urged China to let the yuan, held around 6.8 per dollar since mid-2008, appreciate to rebalance the global economy and shrink Beijing's massive trade surplus with Washington.

Given its economic circumstances, China may not see a strengthening yuan as helpful. At the same time, a U.S. administration facing mid-term elections and needing to create jobs may be attracted to measures within its direct control, such as tariffs, rather than hoping Beijing lets the yuan firm.

China's economy has recovered strongly. December's exports surged 17.7 percent from a year earlier and imports jumped 55.9 percent.

But these blistering figures and a surge in new bank lending in the first week of January have raised fears of economic overheating.

In response, China has begun to roll back the extraordinary policy accommodation used to combat the global financial crisis.

The central bank has raised commercial lenders' reserve requirements and, on Tuesday, increased yields on one-year bills. The Asian Development Bank says more tightening will be needed if China's economy is not to overheat this year.

But while China will wish to avoid overheating, it needs to maintain economic growth. The emphasis may therefore be back on exports. As monetary policy is tightened, China will probably not



## DEEP DIVE Commentary and Analysis

wish to see the yuan appreciate and weigh on exports. Commerce minister Chen Deming said on Tuesday that yuan exchange rate reform would be gradual and that exports would take a long time to recover to pre-crisis levels. On the U.S. side, President Barack Obama's Democrat administration may also have different priorities as mid-term elections approach. Support for the Republicans is rising, as demonstrated in Tuesday's special congressional election in the Democrat bastion of Massachusetts. Obama's November visit to China achieved nothing with regard to securing Chinese acceptance of the need for a stronger yuan. Rather than press a yuan appreciation case that requires Chinese co-operation, the administration is pushing on with other measures to show its determination to safeguard U.S. jobs, measures that may shore up the Democrat vote in the congressional mid-term elections.

A U.S. trade panel approved on Dec. 30 duties of 10-16 percent on Chinese-made steel pipe, used in oil and natural gas production, to counter Chinese subsidies.

On Jan. 5, the United States slapped duties of 43 to 289 percent on imports of more than \$300 million of steel wire decking. These may be small scale measures but they are tangible and unilateral.

Such well-publicized measures tacitly acknowledge that progress on the yuan issue has been disappointing and that a different tack is needed.

At the same time, they camouflage the reality that China cannot succumb to U.S. pressure for a marked appreciation in the yuan that would hurt its global exports.

-- Neal Kimberley is an FX market analysts for Reuters. The opinions expressed are his own --

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