

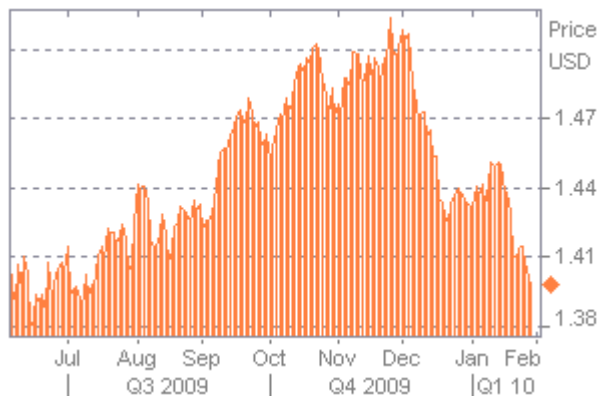
# INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Thursday, January 28, 2010

## CHART OF THE DAY

### Euro/Dollar



Euro fell to a 6-1/2 month low against the dollar on persistent concerns over the fiscal health of Greece and other euro zone countries.

## TODAY'S TOP NEWS

- Reluctant U.S. Senate backs Bernanke for second term
- U.S. durable goods orders edge up
- Obama takes retooled agenda on road after speech
- U.S. Senate backs "paygo" budget-control measure
- Greece seeks no bailout, lashes out at speculators
- **For more stories click here**

## ECON WATCH

FOR FRIDAY JANUARY 29

ET	Indicators	Unit	Reuters	Prior
04:00	EZ Money-M3 annual grwth	%	-0.5	-0.2
04:00	EZ Money - Private loans	%	-0.3	-0.7
05:00	EZ Unemployment rate	%	10.1	10.0
08:30	US Real GDP qq SAAR	%	4.6	2.2
08:30	US Implicit Deflator	%	1.3	0.4
08:30	US Final sales	%	1.6	1.5
08:30	US Core PCE prices	%	1.3	1.2
08:30	US PCE price index	%	2.6	2.6
08:30	US Employment costs	%	0.4	0.4
08:30	CA GDP mm	%	0.2	0.2
08:30	CA Producer prices mm	%	0.4	1.0
09:45	US Chicago PMI	ind	57.4	58.7
09:55	US Reuters/UMich senti	ind	73.0	72.5
09:55	US Current conditions	ind	78.4	78.0
09:55	US Expectations	ind	69.0	68.9

### AMERICAS LOANS FORUM:

The Americas Loans Forum is a chat room hosted by Thomson Reuters LPC, the global leader in syndicated loan market news, data and analysis.

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## MARKETS TODAY

**TODAY'S TOP STORY:** The U.S. Senate approved Ben Bernanke's nomination to a second four-year term running the world's most powerful central bank despite deep misgivings over his perceived policy missteps.  
**For more please click here**

**TREASURIES:** U.S. stock losses inspired a bid for safe-haven U.S. government securities, lifting prices of shorter-dated U.S. govt. debt.

- The U.S. Treasury sold \$32 billion in 7-yr notes at a high yield of 3.127 percent, awarding 36.66 pct of the bids at the high.
- 30-yr bond prices rose 1/32 to yield 4.56 pct.
- 10-yr notes were unchanged at 3.65 pct.
- 2-yr Treasury prices were up 3/32 yielding 0.87 pct.

**FOREX:** The U.S. dollar reached a 6-1/2 month peak against the euro as investors remained anxious about the fiscal health of Greece and other smaller euro zone countries.

- Dollar index surged 0.34 pct at 78.946.
- Euro fell 0.39 pct at \$1.3965. Earlier, fell to \$1.3938, its worst showing since mid-July.
- Euro was down 0.48 pct to 125.52 yen, after hitting a nine-month low of 125.07 yen.
- Sterling shed 0.27 pct at \$1.6124 after S&P's statement.
- Against the yen, dollar fell 0.09 pct to 89.86 yen.

**CORPORATES:** Corporate bond spreads were little changed as investors paused to mull whether last year's rally has narrowed spreads to levels compatible with worries over the pace of economic recovery.

- The CDX.IG-13 index remained unchanged at 95 bps.
- The cost of insuring Greek government debt against default shot up to a record high of 400,500 euros per 10 million euros of exposure at one point, according to five-year CDS prices.
- Mexican state oil company Petroleos Mexicanos launched \$1 bln of 10-yr debt at 250 bps over comparable U.S. Treasuries.

**STOCKS:** U.S. stocks dropped as poor outlooks from Motorola and Qualcomm dented optimism in the technology sector, while worries about Greece's fiscal health dragged on sentiment.

- Dow fell 1.13 pct to 10,120.46, S&P shed 1.18 pct to 1,084.53 and Nasdaq was down 1.91 pct to 2,179.0.
- Qualcomm Inc shares fell 14.24 pct to \$40.48 and Motorola Inc lost 12.43 pct to \$6.48 after both companies gave disappointing outlooks.
- 3M Co fell 1.88 pct to \$80.75 despite posting stronger-than-expected earnings. P&G Co shares rose 1.43 pct to \$61.68.
- S&P financial index fell 0.40 pct, S&P technology was down 2.94 pct.

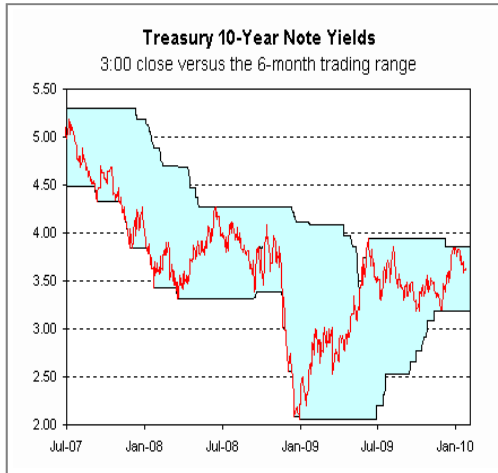
**C & E:** Oil rose rebounding from six-week lows, after Obama's State of the Union address and the Fed's decision to maintain low interest rates revived some confidence about economic growth.

- U.S. crude prices rose 0.11 pct to \$73.75 per barrel.
- Gold was down 0.11 pct to \$1,086 an ounce.
- Reuters-Jefferies index fell 0.44 pct to 267.58.

- **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	0.015	-0.015	0.015	-0.011
3-Mo Bill	0.080	0.070	0.081	-0.001
6-Mo Bill	0.145	0.135	0.147	-0.014
1-Year	0.285	0.275	0.290	-0.026
2-Year	99.992	100.023	0.880	0.086
3-Year	99.867	99.906	1.421	0.098
5-Year	99.242	99.281	2.412	0.098
7-Year	100.797	100.844	3.121	0.055
10-Year	97.672	97.734	3.660	-0.047
30-Year	96.828	96.891	4.571	-0.070

EQUITIES

	INDEX	CHANGE
DJIA	10132.78	-103.38
NASDAQ	2183.89	-37.52
S&P 500	1086.82	-10.68

OIL

	PRICE	CHANGE
NYMEX	73.8	0.1
BRENT	72.2	-0.1

EURODOLLAR FUTURES

	CLOSE	CHANGE
Feb-10	99.740	0.003
Mar-10	99.715	0.005
Jun-10	99.600	0.025
Sep-10	99.345	0.040

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.07	0.14
CBOT 10 yr	117.63	-0.03
CBOT 30 yr	118.13	-0.22

REPURCHASE AGREEMENTS

G/C	MORTGAGE REPOS	
O/N	0.190	O/N 0.200
2-Week	0.190	2-Week 0.200
1-Month	0.200	1-Month 0.210
3-Month	0.200	3-Month 0.240
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX
O/N	0.190	10:00 AM 0.130
2-Week	0.190	3:00 PM 0.128
1-Month	0.200	
3-Month	0.220	

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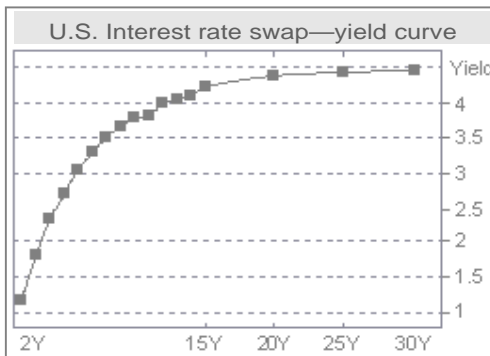
	SPREAD		RATE	
2-Year	24.75	28.75	1.12	1.14
3-Year	33.00	37.00	1.74	1.76
5-Year	27.75	31.75	2.69	2.69
7-Year	15.00	19.00	3.27	3.26
10-Year	10.25	14.25	3.75	3.74
30-Year	-12.75	-8.75	4.44	4.42

CURRENCIES

	BID	ASK
Euro	1.3980	1.3982
Sterling	1.6127	1.6132
JP Yen	89.89	89.92
Swiss Franc	1.0511	1.0514
Can Dollar	1.0653	1.0658
Mexico	13.0389	13.0450

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.120	0.150	-	-
1-Month	0.180	0.280	0.125	0.135
3-Month	0.240	0.400	0.144	0.154
6-Month	0.250	0.450	0.169	0.179
12-Month	0.650	0.950	0.331	0.341



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

Open	0.1300	1m	0.2087
High	0.1400	3m	0.2412
Low	0.0900		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	12	11	1
3-Year	1.375	09/01/2013	0	21	-
5-Year	2.875	09/02/2015	30	29.5	2.73
7-Year	5.125	18/10/2016	24	0	3.37
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	37	36.5	4.94

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	9.5	0	0.98
3-Year	1.75	22/02/2013	0	28	-
5-Year	2.625	20/11/2014	20	15	2.63
7-Year	5.25	15/09/2016	21.5	20.75	3.34
10-Year	3.75	27/03/2019	24.5	23.5	3.92
30-Year	6.25	15/07/2032	38	37.25	4.95

Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.1970	105.2170	2.542
FHLMC	5.0	105.1870	105.2070	2.555

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.2770	105.2970	2.828
FHLMC	5.5	105.3060	106.0060	2.733
GNMA	5.5	105.2000	105.2200	3.576

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

Nondefense Capital Goods Ex-Aircraft: Orders and Shipments  
3-month moving averages in blns of dollars



## TODAY'S TOP NEWS

**Reluctant U.S. Senate backs Bernanke for second term**

The U.S. Senate approved Ben Bernanke's nomination to a second four-year term running the world's most powerful central bank despite deep misgivings over his perceived policy missteps.

The Senate voted 70-30 to confirm Bernanke, after clearing a procedural hurdle with the support of 77 senators.

Bernanke, who has been credited with steering the U.S. economy through a wrenching financial crisis but who is also under fire for policies that set the stage for the turmoil, encountered the stiffest opposition the Senate has put up in the three decades it has voted on nominees to head the U.S. central bank.

Separately, U.S. Treasury Secretary Timothy Geithner said the Senate "did the right thing" in confirming Federal Reserve Chairman Ben Bernanke for a second term.

**Obama takes retooled agenda on road after speech**

President Barack Obama took his retooled agenda on the road, hoping to convince Americans he is serious about focusing on jobs and the economy as he seeks to dig out of his deepest political rut since taking office.

The morning after a State of the Union address in which he tried to reconnect with the public, Obama flew to Florida to hold a townhall-style meeting and unveil \$8 billion in grants for high-speed rail projects the White House says will create employment and transform U.S. train travel.

He declared job creation his "number one focus in 2010" and vowed not to abandon his struggling healthcare overhaul, despite his Democratic party's stunning loss of a pivotal Senate seat last week that imperiled his legislative agenda.

In a sign of the difficulties facing Obama, Senator John McCain, his former Republican presidential rival, told CBS he would not back the president's push for a new jobs bill, saying it would just be a repeat of failed policy.

The White House said the rail projects Obama was unveiling would save or create thousands of jobs and would be "one of a number of job initiatives" the president will lay out in the coming weeks. He pledged tough new rules for Wall Street but said he was "not interested in punishing banks," appearing to retreat slightly from some of his fiery rhetoric.

Separately, U.S. Treasury Secretary Timothy Geithner said the Obama administration will propose a \$5 billion expansion in a green energy manufacturing tax credit when it announces its new fiscal budget next week.

**Greece seeks no bailout, lashes out at speculators**

Greece has asked no country for a bailout and is the victim of speculators intent on attacking a "weak link" in the euro zone, its leader said as the premium on its debt hit a new high.

Greek Prime Minister George Papandreou said his country was being targeted by speculators with ulterior motives opposed to the single European currency.

Germany and France denied a media report that they were planning to give financial aid to Greece, whose budget deficit hit an estimated 12.7 percent in 2009. Athens says it is seeking funds only through the markets, mainly in Europe.

Papandreou told the World Economic Forum that Greece would not leave the euro area and would use the discipline of membership to slash its budget deficit and make long-postponed structural economic reforms. Spanish Prime Minister Jose Luis Rodriguez Zapatero rallied to Greece's defense and told the same panel that those putting pressure on the euro now had opposed its creation at the outset in the 1990s.

**U.S. durable goods orders edge up, jobless claims dip**

New orders for long-lasting U.S. manufactured goods edged higher in December and the number of workers filing applications for jobless aid fell last week, indicating the economy remains on a recovery path.

The Commerce Department said durable goods orders rose 0.3 percent last month, held back by a surprise drop in civilian aircraft orders that analysts saw as temporary. The gain lagged economists expectations for a 2 percent rise.

Details of the report were much stronger, however, with a proxy for business spending plans -- non-defense capital goods orders excluding aircraft -- increasing a solid 1.3 percent.

Civilian aircraft bookings fell 38.2 percent last month, building on a 40.0 percent drop in November, the Commerce Department said. New durable goods orders excluding transportation rose 0.9 percent last month after increasing 2.1 percent in November, the department said. Shipments surged 2.9 percent last month. -- the biggest rise since July.

On the jobs front, the Labor Department reported that initial claims for state unemployment benefits dropped 8,000 to 470,000 last week, less than economists had expected, after rising for three weeks in a row.

**U.S. Senate backs "paygo" budget-control measure**

The U.S. Senate approved a budget-control measure that would require new spending to be offset with cuts elsewhere, an approach that Democrats say helped turn deficits to surpluses in the 1990s.

The Senate approved the so-called "paygo" legislation by a party-line vote of 60 to 40.

Republican Judd Gregg said lawmakers would find ways around the limits, just as they have set aside existing, weaker paygo rules to approve \$1 trillion in spending.

The U.S. Senate voted narrowly to increase the government's borrowing authority to \$14.3 trillion, which would allow the Treasury Department to continue servicing the country's spiraling national debt through most of 2010.

The 60 to 40 vote ensures that the Democratic-led chamber will not have to sign off on another unpopular increase before the November congressional elections.

Separately, Senate Democratic leader Harry Reid said that his party would unveil a major jobs "agenda" next week in the U.S. Senate. Reid told reporters the package would include long-term and short-term job-creation measures, and take a broad view of the unemployment situation in the United States.

**U.S. \$32 bln 7-year auction draws strong demand**

The U.S. government sold \$32 billion worth of seven-year debt in a well-bid auction that caps a week of solid bond offerings totaling \$118 billion.

The sale attracted strong overall demand, with bids totaling 2.85 times the amount on offer versus the average of 2.57 in last year's auctions of seven-year debt.

Yields were below expectations, based on trade in the when-issued market at the bidding deadline, indicating that investors were willing to pay a small premium in price to get the Treasury notes. Foreigners and large institutional investors showed below-average demand, based on the indirect bidding category, which accounted for 51 percent of the sale.

That was under the average of 59.86 percent in the sales taking place since June 2009, a key benchmark for comparisons after changes in the way calculations are made.



## TODAY'S TOP NEWS

**UK bank system no longer ranks among safest-S&P**

Standard and Poor's reiterated its view that the United Kingdom is no longer among the most stable and low-risk banking systems globally, adding color to a banking industry risk assessment revealed last year.

The rating agency placed the UK's banking system in group 3 out of its 10 BICRA categories on Dec 21 2009, alongside the banking system of the USA.

S&P said in its statement that the action was due to the Britain's weak economic environment, the reputational damage wrought upon the banking industry, and high dependence on state-support programs of a significant proportion of the industry.

The agency also said that the deleveraging process of households, government and companies would weigh on the economy and therefore the banks' financial performance.

**Euro zone sentiment jumps in Jan, recovery intact**

Economic sentiment in the euro zone strengthened much more than expected in January and December while German unemployment rose less than forecast this month, data showed, pointing to continued economic recovery.

A monthly survey by the European Commission showed the ESI rose to 95.7 points -- well above the 92.4 forecast by economists in a Reuters poll -- from 94.1 in December.

Economists also said sentiment in France, Italy and Germany was closer to historical averages than in Spain, Portugal and Greece.

German Economy Minister Rainer Bruederle told parliament that a number of euro zone countries were "dangerously" weak, which could have a fatal impact on the rest of the euro zone.

The January rise in euro zone sentiment stemmed mainly from a 5-point improvement in that for retail trade, to -5 points.

There were 2-point improvements in the industrial and services sectors to -14 and -1 respectively. Consumer sentiment stagnated at -16, while construction fell by 1 point to -29. Expectations of price trends over the next 12 months among consumers jumped to -2 from -6 points as fewer expected prices to decline.

**Policymakers warn on recovery, stimulus exit**

Top policymakers warned the world economy is not out of the woods and a global recovery is still far from secure, urging caution as central banks work on withdrawing critical support.

China's Vice Premier Li Keqiang, the man tipped to become the country's next premier, said there were still "twists and turns" ahead as the world pulls out of recession, echoing calls to caution from bankers and other leaders at the annual World Economic Forum in the Swiss ski resort of Davos.

His comments were echoed by South Korean President Lee Myung-bak and urged member countries to tread gently as they begin to unwind extraordinary monetary stimulus measures.

John Lipsky, First Deputy Managing Director of the IMF, told Reuters even signs of a recovery and a move to raise growth forecasts showed differences in the speed of recovery: "Don't exit too early, think about the long term," he said.

**Argentina revises SEC filing ahead of debt swap**

Argentina amended a filing for a debt offering with the U.S. SEC, mentioning controversy over inflation data and the latest asset freezes imposed on behalf of holders of defaulted bonds.

Argentina submitted a shelf filing for the sale of up to \$15 billion in debt instrument in the United States on Dec. 16 as it prepares to swap up to \$20 billion in untendered bonds left over from its massive 2002 default.

The exchange is expected to launch in the coming weeks.

The SEC had requested more information from the government, Economy Minister Amado Boudou said earlier this month.

The new document is four pages longer than the original and contains a more detailed description of the risks associated with Argentina, including private analysts' doubts over official inflation data.

The document also gave more details of court asset freezes imposed on behalf holders of defaulted Argentine bonds in international courts.

## NEXT UP

**POLL-U.S. Q4 GDP seen at +4.6 pct vs +2.2 pct in Q3**

Economic growth in the fourth quarter likely accelerated to an annual rate of 4.6 percent, the fastest pace in nearly four years, boosted by a dramatic swing in inventories. Businesses have in previous quarters aggressively slashed stocks of unsold goods to cope with weak domestic demand, weighing down sharply on GDP.

The median forecast is for fourth quarter gross domestic product to quicken to an annual rate of 4.6 percent from 2.2 percent in the third quarter. Forecasts range from a growth pace of 3.5 to 7.5 percent. The pace of inventory liquidation slowed in the third quarter and contributed to the first economic expansion since the second quarter of 2008.

Final sales of domestic product are expected to rise less strongly. The median forecast for final sales of domestic product -- GDP minus change in private inventories -- is for a rise to 1.6 percent from a 1.5 percent increase in the third quarter.

Consumer spending is expected to have shown some resilience in the fourth quarter, despite the highest unemployment rate in just over a quarter century. Export growth also likely supported the economy in the fourth quarter.

**Poll-Investors cut back on equities**

Global investors cut back on equities in January in the face of worries about the economy, potentially tighter monetary policy and in reaction to last year's stellar gains.

Reuters poll of 44 leading investment houses in the United States, Japan, Britain and continental Europe showed an average portfolio holding 55.1 percent of its assets in equities.

This was down from 56.2 percent in December and level with what they held in March last year when the global rally in riskier assets began.

Bond holdings were 33.7 percent compared with 33.8 percent in December while cash coffers dropped to 4.1 percent of a balance portfolio compared with 4.4 percent.

The remaining percentage of flowed into alternative investments such as property and hedge funds.

On average, the 44 respondents were moderately overweight in equities and neutral in all other major assets, suggesting that the long-term view of a recovering world economy is still in place. Investors, however, have been battered so far this year by worries about the removal of pump-priming liquidity from central.



## DEEP DIVE Commentary and Analysis

## COLUMN-Housing's Humpty Dumpty moment

By Jim Saft

All the King's horses and all the King's men have been busy propping up the U.S. housing market but sometime this year, perhaps soon, it will face a Humpty Dumpty moment.

While it gets a lot less attention than the banking bailout, the official forces targeted at supporting house prices are truly vast; a generous tax break for buyers and a mortgage market that has essentially been nationalized.

That's bought a recovery of sorts -- Standard & Poor's/Case-Shiller home-price index released on Tuesday showed that in 20 major cities home prices rose 0.2 percent on a seasonally adjusted basis between October and November, despite a national unemployment rate of 10 percent and a slow-motion cascade of foreclosures.

But like the egg in the nursery rhyme, which once broken cannot be reassembled, housing still faces some pretty horrendous fundamentals. It needs a strong recovery in employment to arrive before political consensus for housing support cools. (Full disclosure: I just bought a house, but hey, everybody's got to live somewhere.)

Already there are signs that housing may be faltering. Existing home sales declined sharply in December, though this was partly because many rushed to close purchases before a now extended deadline for tax rebates expired on Dec. 1. Housing starts too fell in the month and, significantly, the Federal Reserve removed language pointing to improvement in housing from its statement accompanying its decision to keep interest rates at record lows.

The amount of official support housing has gotten is stunning. Between Fannie Mae, Freddie Mac and the Federal Housing Administration, the mortgage market is getting more direct government support than ever before. FHA loans, which can be made to borrowers with small down payments, have been especially important given bank lenders' new-found preference to lend to buyers who can put up 20 to 30 percent of the purchase price. The FHA, facing rising delinquencies, is tightening terms to borrowers and may ultimately need to cut back on lending or receive additional support.

As well, the Federal Reserve will have bought about \$1.25 trillion of mortgage bonds by the end of the first quarter, bonds which have become a political hot potato due to Congressional ire. If the Fed stops buying, rates will rise by at least a half a percentage point.

A program of tax credits has been extended through the Spring, but it is likely that these types of incentives simply move demand forward. Housing will soon need a strong jobs recovery to remain stable, something far from guaranteed.

## CASH FLOWS NEVER LIE

Valuation is always a matter of opinion, but cash flow cannot be faked; without loose lending, house prices ultimately are ratified by the rent property can command or the amount of their earnings people are willing to allocate to buying. Neither measure is reassuring for housing right now; rents nationally fell something on the order of 3 percent last year while stagnant personal income and high unemployment spell trouble for owner-occupied housing.

Remember too the relationship between unemployment and housing; high unemployment is bad for house prices but not nearly as bad as sustained high unemployment. As economists Carmen Reinhart and Kenneth Rogoff detail in their book, *This Time is Different*, one effect of a typical banking crisis is that it raises unemployment rates by seven percentage points and that, and this is worse for housing markets, unemployment re-

mains elevated for five years. Ask yourself, what would be the effect on house prices if unemployment was still at 8 percent or more in two or three years?

For certain many borrowers are hanging on to their houses for dear life and against their own best interests. Many of these will convert into foreclosures as time passes as employment fails to materialize.

This is probably the untold story of housing stabilization. It has been done at huge expense in order to avoid finding a clearing price, to avoid allowing prices to come down to where natural and reliable demand would take them. FHA, Fannie and Freddie lending and Federal Reserve intervention have all combined to prop prices up, a policy intended to avoid exerting further pressure on the banking system. But in order to do this, huge amounts of capital are being deployed to keep housing expensive that could otherwise find better uses such as developing new technologies or increasing export competitiveness. Less of that kind of productive investment is going to happen because we've made a decision to not acknowledge our error in housing, allow it to fall and move on.

This is a Japan solution, and we'll risk getting a Japan outcome: an extended resolution. This implies another leg down for housing, but perhaps a slow grinding fall rather than a tumble.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

## Risks to banks once cheap govt-backed debt matures

By John Parry

Emergency funding the U.S. government provided during the credit crisis has left financial institutions with huge cut-price loans that could harm banks' profits and economic growth once borrowing costs rise.

Banks that borrowed cheaply in the corporate bond market with a government guarantee will see their borrowing costs rise sharply once the debt matures, analysts said. That may swell bank expenses and constrain their ability to lend.

By some time in 2012, about \$309 billion of government-guaranteed debt outstanding under the Temporary Liquidity Guarantee Program (TLGP) will mature. Banks will have to refinance with their own stand-alone debt and will likely pay bondholders much higher yields.

"The rise in debt costs...will implicitly reduce banks' ability to lend," said Tim Backshall, chief strategist with Credit Derivatives Research, LLC.

The Program was one of many emergency measures the government brought in at the height of the financial crisis in late 2008 to stop lending markets from freezing up and prevent the financial system imploding.

Like other government stimulus programs, it has gone from reassuring financial markets to worrying them as investors await their eventual demise.

Back in 2008, investors were loath to buy any banks' stand-alone debt, plowing money instead into the securities issued under the TLGP program and driving their yields down. Bond yields and prices move inversely.

Backshall estimates the average yield of bonds issued under the TLGP program is about 0.7 percent.

But if banks issue new debt three years from now to replace the TLGP debt, the average yield could be as high as 4.7 percent for five-year maturities, Backshall said. That's based on forward markets that bet on future valuations.

The higher interest they will pay bondholders will push up interest expenses -- money paid out in interest on debt, Backshall



## DEEP DIVE Commentary and Analysis

warned.

"Banks' ability to lower interest expense over the past year due to the TLGP is tremendously misleading and we feel the TLGP represents a huge burden/drag on financial earnings in the coming years," Backshall wrote in a note last week.

If yields rise that much, Citigroup, Wells Fargo & Co, Bank of America and JPMorgan would all face a rise in annual interest expense of between 13 percent and 17 percent, Backshall estimates, which would be a major constraint on bank earnings. Contacted for this report, these banks either said they did not have forecasts or declined comment.

There are other options open to banks if refinancing at higher rates in intermediate and longer-term corporate bonds proves too expensive.

"They could perhaps borrow more overnight, go to the commercial paper market more aggressively, or shift to deposit-based funding," said Mark Freeman, portfolio manager with Westwood Holdings Group in Dallas, Texas.

Even so, the rise in borrowing costs via the corporate bond market will present a tough challenge. "They will have to be crea-

tive," Freeman said.

But for now, the TLGP subsidy for big institutions "has substantially lowered these banks' cost of capital and provided them with an amazing competitive advantage over the smaller and medium-sized banks across the country," said Haag Sherman, managing director of Salient Partners, a Houston based investment firm.

Bond investors are more confident in buying the debt of behemoth banks, which many believe are still implicitly backed by the government because it views these as too big to fail.

But investors are more wary of smaller regional banks, which are under growing pressure from a commercial real estate slide. Differences between yields of the bonds issued by bigger and smaller banks show this divergence in their costs to borrow.

For instance, a five-year note issued by JPMorgan currently yields about 3.25 percent while a similar maturity note from mid-sized regional bank Zions Bancorp yields about 8.71 percent, according to MarketAxess.

## AMERICAS LOANS FORUM

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