

INSIDE DEBT

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Monday, February 8, 2010

CHART OF THE DAY

Speculators increase bets against the euro



Investors increased bets on further dollar gains in the latest week. Net long positions in the dollar were at their highest in about 11 months, data from U.S. CFTC showed.

TODAY'S TOP NEWS

- Greek unions promise strikes, euro jitters persist
- Fed group eyes insurance fund for key market
- Fed's Yellen: Low U.S. rates stimulatory for China
- U.S.'s Geithner-No double-dip slump but recovery slow
- U.S. job market gauge rises for 5th month
- ECB's Nowotny: Eurozone bonds no "crisis instrument"
- CIT sets John Thain's salary at \$6 million a year
- NY's Cuomo: Two firms settle role in pay-to-play

ECON WATCH

FOR TUESDAY FEBRUARY 9

ET	Indicators	Unit	Reuters	Prior
02:00	DE CPI final mm	%	-0.6	0.8
02:00	DE CPI final yy	%	0.8	0.9
02:00	DE HICP final mm	%	-0.7	0.9
02:00	DE HICP final yy	%	0.7	0.8
02:00	DE Imports mm sa	%	3.0	-5.9
02:00	DE Exports mm sa	%	0.7	1.6
02:00	DE Trade balance, EUR, sa	bln	15.0	17.2
04:30	GB Trade Balance GBP	bln	-6.63	-6.784
04:30	GB Trade Balance, Non-EU	bln	-3.15	-3.032
10:00	US IBD Cons. Conf.	ind	-	48.8
10:00	US Wholesale inventories	%	0.5	1.5
10:00	US Wholesale sales	%	1.0	3.3
18:50	JP Corp goods price m/m	%	0.1	0.1
18:50	JP Corp goods price y/y	%	-2.3	-3.9
18:50	JP Machinery orders	%	8.0	-11.3

MARKETS TODAY

TODAY'S TOP STORY: Greek civil servants threatened to stage more strikes in protest at government austerity measures, further fuelling market concerns over fiscally fragile euro zone members and weighing on the single currency and bonds. **For more please click here**

TREASURIES: U.S. Treasury debt prices fell slightly ahead of new supply, although losses were limited as worries persisted over the soundness of some European countries' debt.

- 10-yr Treasury prices fell 1/32 to yield 3.57 pct.
- 30-yr bond prices were rose 10/32 to yield 4.5 pct.
- 5-yr Treasury prices fell 1/32 yielding 2.24 pct.
- 2-yr Treasury prices were unchanged to yield 0.78 pct.

FOREX: The U.S. dollar drifted lower as a modest recovery in overseas stock markets and commodities enhanced risk appetite and prompted investors to venture into other higher-yielding currencies.

- The euro has shed nearly 10 pct from a 15-month high of \$1.5145 reached in late November over growing fears Portugal and Spain could face the same fiscal problems as Greece.
- The euro fell 0.03 pct at \$1.366, not far from \$1.3583 reached on Friday, its lowest since May.
- Dollar was down 0.26 pct at 89.27 yen.
- The euro fell 0.29 pct to 121.95 yen.
- The dollar index fell 0.11 pct at 80.354.
- Sterling rose 0.06 pct to \$1.5601.

CORPORATES: U.S. corporate bonds sold off as worries about Greece and some other European sovereign debt markets weighed on the price of riskier bonds worldwide.

- The CDX.IG-13 index widened by about 5 bps to 106 bps.
- The cost of insuring against a Greek sovereign default was at 407,000 euros per 10 million euros of exposure.

STOCKS: U.S. stocks fell on fears that possible fallout from the euro zone's sovereign debt troubles might force banks to raise capital, diluting the holdings of existing share owners.

- Dow fell 1.03 pct to 9,908.77, S&P was down 0.88 pct to 1,056.76 and Nasdaq shed 0.7 pct to 2,126.05.
- BofA shares dropped 3.47 pct to \$14.48, while JPMorgan slipped 1.57 pct to \$37.70, and Citigroup shed 2.17 pct to \$3.15.
- The S&P financial index dropped 2.20 pct, while KBW bank index dipped 1.47 pct.
- Home Depot shares rose 2.18 pct to \$28.59.
- Shares of Hasbro rose 12.69 pct to \$34.71 and Caremark Corp was up 5.31 pct to \$32.72.

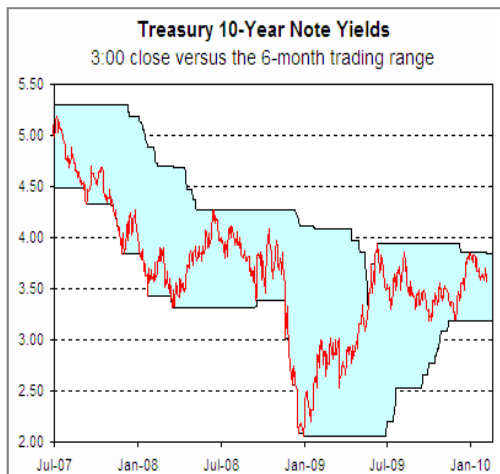
C & E: Oil rose nearly 1 pct, after three sessions of losses, as a weaker U.S. dollar, cold weather and geopolitical disputes provided support.

- U.S. crude prices rose 0.79 pct to \$71.75 per barrel.
- Gold shed 0.27 pct to \$1,062.7 an ounce.
- Reuters-Jefferies index was up 1.15 pct to 261.52.

- 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	0.045	0.01	0.046	0.004
3-Mo Bill	0.100	0.085	0.101	0.004
6-Mo Bill	0.165	0.160	0.167	0.012
1-Year	0.280	0.280	0.284	0.008
2-Year	100.156	100.188	0.796	-0.035
3-Year	100.250	100.289	1.288	-0.059
5-Year	99.930	99.977	2.265	-0.098
7-Year	100.547	100.594	3.037	-0.156
10-Year	98.203	98.266	3.594	-0.156
30-Year	97.609	97.688	4.522	0.102

EQUITIES

	INDEX	CHANGE
DJIA	9969.84	-42.32
NASDAQ	2138.77	-2.35
S&P 500	1063.54	-2.67

OIL

	PRICE	CHANGE
NYMEX	71.8	0.6
BRENT	70.1	0.5

EURODOLLAR FUTURES

	CLOSE	CHANGE
Feb-10	99.745	0.005
Mar-10	99.695	-0.005
Jun-10	99.565	-0.030
Sep-10	99.350	-0.045

FUTURES

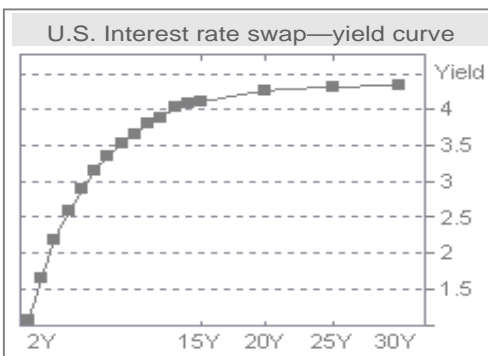
	PRICE	CHANGE
CBOT 5 yr	116.86	-0.22
CBOT 10 yr	118.69	-0.17
CBOT 30 yr	119.19	-0.31

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.180	O/N	0.180
2-Week	0.200	2-Week	0.210
1-Month	0.200	1-Month	0.220
3-Month	0.230	3-Month	0.250
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.170	10:00 AM	0.120
2-Week	0.200	3:00 PM	0.120
1-Month	0.210		
3-Month	0.240		

IR SWAPS <19901>

	SPREAD		RATE	
2-Year	28.50	32.50	1.07	1.10
3-Year	38.00	42.00	1.66	1.68
5-Year	32.25	36.25	2.58	2.59
7-Year	13.75	17.75	3.17	3.17
10-Year	8.00	12.00	3.67	3.66
30-Year	-16.75	-12.75	4.35	4.33



CURRENCIES

	BID	ASK
Euro	1.3671	1.3674
Sterling	1.5613	1.5618
JP Yen	89.32	89.34
Swiss Franc	1.0715	1.0718
Can Dollar	1.0725	1.0730
Mexico	13.1966	13.2022

FED FUNDS NYFRSM - 10AM

Open	0.1400	1m	0.2125
High	0.2500	3m	0.2463
Low	0.1000		

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.140	0.160	-	-
1-Month	0.180	0.280	0.133	0.143
3-Month	0.240	0.400	0.149	0.159
6-Month	0.250	0.450	0.179	0.189
12-Month	0.650	1.000	0.318	0.328

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	15	14	0.94
3-Year	1.375	09/01/2013	24.5	23	1.53
5-Year	2.875	09/02/2015	36	34	2.62
7-Year	5.125	18/10/2016	0	22	-
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	0	35	-

ACTIVE FREDDIE MAC AGENCIES

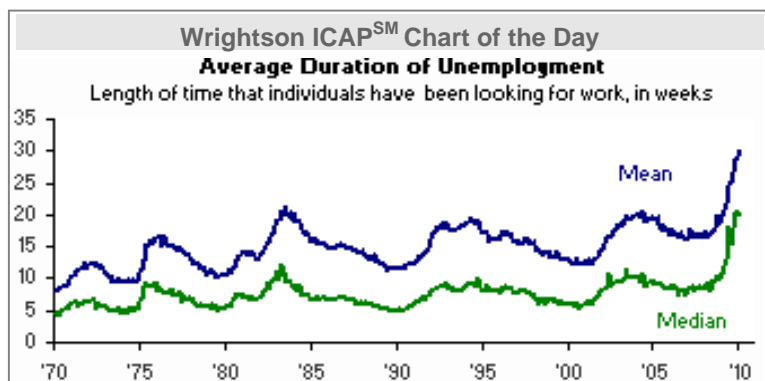
TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	11	0	0.89
3-Year	1.75	22/02/2013	30	29.5	1.59
5-Year	2.625	20/11/2014	22	21	2.48
7-Year	5.25	15/09/2016	18.75	18.25	3.22
10-Year	3.75	27/03/2019	27.5	27	3.87
30-Year	6.25	15/07/2032	45	0	4.97

Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.2400	105.2600	2.491
FHLMC	5.0	105.2400	105.2600	2.491

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	106.0800	106.1000	2.673
FHLMC	5.5	106.0900	106.1100	2.599
GNMA	5.5	106.0500	106.0700	3.411



TODAY'S TOP NEWS

Greek unions promise strikes, euro jitters persist

Greek civil servants threatened to stage more strikes in protest at government austerity measures, further fuelling market concerns over fiscally fragile euro zone members and weighing on the single currency and bonds.

After sinking to its lowest level against the dollar in over eight months last week, the euro remained under pressure, hovering below the \$1.37 mark, despite a concerted effort at the weekend by European policymakers to calm investor nerves.

Under pressure from the markets, governments in Athens, Lisbon and Madrid are pushing through budget cuts to get their fiscal houses in order and restore confidence in their economies and ability to service their debt.

A failure to press ahead with austerity measures is likely to increase pressure on their bonds and push up borrowing costs in a vicious circle which economists say could force the bloc to bail out one of its members or even prompt a country to be expelled from the 11-year old currency union.

Separately, the euro and growth-linked currencies fell as investors unwound risky trades amid growing worries about eurozone's debt problems, dismissing assurances from European finance ministers at the weekend. European ministers told their counterparts at a G7 meeting on Saturday they would make sure Greece sticks to its budget-cutting plan.

Fed's Yellen: Low U.S. rates stimulatory for China

The U.S. Federal Reserve's ultra-easy monetary policy is fueling concerns in Hong Kong and China over asset bubbles and prospects for dollar weakness, which could hurt their dollar-denominated investments, a top Federal Reserve official said.

China, however, could adjust its exchange rate to allay inflationary worries, San Francisco Fed President Janet Yellen said in an Economic Letter.

"Because both the Chinese and Hong Kong economies are further along in their recovery phases than the U.S. economy, current U.S. monetary policy is likely to be excessively stimulatory," Yellen said in the letter. "However, as both Hong Kong and the mainland are currently pegging to the dollar, they are both to some extent stuck with the policy the Federal Reserve has chosen to promote recovery." Still, China's currency peg is less rigid than Hong Kong's, and prior to the crisis China had been gradually raising the exchange rate.

Separately, the U.S. Federal Reserve could sell off some assets later this year in an effort to whittle down its bloated balance sheet to avoid inflation, a senior Federal Reserve official said.

The Obama administration and U.S. lawmakers are missing an opportunity to revamp the U.S. housing finance system, which should be central to regulatory reform, he added.

U.S. job market gauge rises for 5th month -Conf Board

The U.S. job market improved in January for the fifth consecutive month, pointing to possible job growth in the first quarter of this year, a research group said.

The Conference Board said its Employment Trends Index climbed to 93.2 in January from an upwardly revised 92.3 in December, which was originally reported as 91.8.

It was the highest index level reading since January 2009, when it stood at 93.8. The index is still down 0.7 percent from one year ago, according to the group.

"The continued rise in the Employment Trends Index makes us more optimistic that job growth will resume in the first quarter of 2010," said Gad Levanon, associate director of macroeconomic research at The Conference Board.

Fed group eyes insurance fund for key market

Banks, investors and industry groups last week discussed creating a backstop insurance fund among other proposals to lessen the risk a distressed dealer could trigger a crisis in the world's largest funding market.

Participants in the tri-party repurchase market have been tasked by the central bank with coming up with reforms to strengthen the market which, at its peak, financed more than \$2.8 trillion in securities per day.

The market participants discussed two main proposals for dealing with a defaulted dealer.

Under the first proposal, a so-called emergency bank would step in as a counterparty on a defaulted dealer's trades to provide temporary liquidity to the dealer's lenders. Losses would ultimately be guaranteed by an insurance fund similar to the FDIC which provides insurance against failed banks.

All dealers would contribute to this FDIC-like fund, paying premiums assessed according to their portfolios and the duration of their tri-party trades, according to the documents.

Under the second proposal, a special purpose vehicle (SPV) would take on the troubled portfolio, acting as a new counterparty. Holders of notes issued by the SPV would then ultimately finance the losses of lenders to the defaulted dealer.

U.S.'s Geithner-No double-dip slump but recovery slow

The risk the U.S. economy will slip back into recession is lower now than at any time in the past year, U.S. Treasury Secretary Timothy Geithner said, while conceding that recovery will be slow and uneven.

In an interview on ABC News' "This Week," Geithner dismissed concerns that rising U.S. indebtedness might put pressure on the United States' prized triple-A credit rating.

The U.S. economy expanded at an annual rate of nearly 6 percent in the fourth quarter of 2009 and Geithner said it was definitely "healing" after the financial crisis that drove it into recession in late 2007.

Separately, U.S. President Barack Obama said the U.S. economy has turned the corner and resumed growth. "We are seeing the corner turn on the economy growing again," he said in an interview with CBS television news. Obama said companies were beginning to hire again, but "it's not happening as fast as we'd like."

ECB's Nowotny: Eurozone bonds no "crisis instrument"

Euro zone countries should not issue joint bonds as a way to allow less solvent countries to raise debt at the expense of others, ECB Governing Council member Ewald Nowotny was quoted as saying.

"To issue euro zone bonds as something like a crisis instrument to allow less solid countries to raise cheaper debt at the expense of others, that's absolutely unrealistic and to be rejected," Nowotny told newspaper Wiener Zeitung.

However, he added in an interview that such joint bonds would be a good idea to make euro zone bonds more attractive compared with U.S. Treasuries, and that they would help make the euro currency more attractive.

Nowotny also said that new countries wishing to adopt the euro needed to fulfil strict criteria, and that he saw good chances that Estonia would meet this test in 2011.

Separately, a leading member of Chancellor Angela Merkel's conservatives has backed Axel Weber to become the next ECB president, in a sign of mounting support for the head of the German Bundesbank.



TODAY'S TOP NEWS

CIT sets John Thain's salary at \$6 million a year

CIT Group Inc said its new Chief Executive John Thain will get an annual base salary of \$6 million, most of which is in stock, and a bonus of up to another \$1.5 million, in a nod to compensation practices popularized by the Obama administration's pay czar.

The former Merrill Lynch & Co CEO's salary includes \$500,000 in cash, \$2.5 million of restricted CIT stock with a holding period of one year and \$3 million in stock restricted for three years, the company said in a regulatory filing.

Compensation experts said paying stock as a salary is a good way to offer potentially huge payouts to executives, without paying large bonuses that attract public ire.

Thain's shares will rise or fall in value along with the fortunes of CIT, giving him an incentive to work to improve the fortunes of the lender that just emerged from bankruptcy reorganization.

Paying relatively high salaries largely in stock was an idea put into practice by pay czar Kenneth Feinberg, who is in charge of setting compensation levels for top employees at companies that received multiple U.S. bailouts, such as AIG Inc.

NY's Cuomo: Two firms settle role in pay-to-play

Israeli venture capital firm Markstone Capital Group LLC will pay \$18 million to settle its role in an ongoing corruption probe of New York state's pension fund, Attorney General Andrew Cuomo said.

Wetherly Capital Group will return \$1 million associated with the pension investments, Cuomo said in a statement.

Cuomo said \$120 million has been collected for the state and its \$126 billion pension fund from a probe into the way placement agents exploited their political ties under former Democratic Comptroller Alan Hevesi to win lucrative investment contracts for their clients.

Founding partner Elliott Broidy resigned in December, pleaded guilty to a felony and has been cooperating with Cuomo's probe. Broidy gave gifts, political contributions and other "benefits" worth more than \$1 million to the top decision makers at the state pension fund, Cuomo said.

FairPoint aims to cut debt by two-thirds

Telecommunications provider FairPoint Communications Inc filed a delayed plan of reorganization that calls for cutting debt by about two-thirds and distributing millions of new shares to claim holders.

The company proposed cutting \$1.8 billion in debt and issuing millions of new shares, subject to creditor and bankruptcy court approval.

The company said in court filings that \$2.1 billion in allowed pre-petition credit agreement claims could expect a recovery of about 87.9 cents on the dollar in cash and new shares.

The largest class of unsecured creditors will receive stock and other instruments, representing an 8-percent stake in the company, said Cummings. The recovery represents about 17 cents on the dollar.

Subject to certain conditions, some 47 million new common shares will be distributed to holders of Class 4 pre-petition credit agreement claims, and 4 million shares will be distributed to Class 7 unsecured claim holders.

Japan bank lending slides as funding demand weak

Japanese bank lending logged its biggest annual fall in more than four years in January as companies faced with overcapacity and a murky economic outlook steered clear of borrowing for capital investment purposes.

The softness in domestic demand could also be seen in Japan's current account surplus, which surged more than fivefold in the year to December thanks to a recovery in exports.

Japan's current account surplus rose 452.8 percent in the year to December, supported by a recovery in exports, which some said would continue to support the economy.

Separately, BoJ Deputy Governor Hirohide Yamaguchi said the Japanese economy could hit a soft patch until around the summer before returning to a more sustainable recovery path. "We expect the recovery to continue. But the economy will be in a severe condition until the summer. Quarter-on-quarter growth won't be big and we may even hit a soft patch," Yamaguchi said at lower house budget committee.

NEXT UP

TREASURY OUTLOOK-A solid kick-off seen for refunding

The U.S. Treasury should have an easy kick-off on Tuesday to its \$81 billion quarterly refunding, as anxiety over fiscal problems in Europe has fueled a safe-haven bid for U.S. government securities.

Expectations that the Federal Reserve will leave interest rates near zero in 2010 will help fuel domestic and overseas appetite for the \$40 billion in three-year notes for sale, analysts and investors said on Monday.

The three-year auction will be followed by a \$25 billion sale of 10-year notes on Wednesday and \$16 billion in 30-year bonds on Thursday.

The U.S. government's borrowing has surged since last year as it has scrambled to make up for a shortfall in tax receipts due to the recession and to fund its stimulus and bailouts.

This quarter's refunding is expected to repay \$48.3 billion on the maturing securities investor own and to raise \$32.7 billion in new cash. While the United States' huge debt load has raised eyebrows, investors have been rattled by the fiscal problems in Greece and fanned speculations whether its European neighbors would have to bail it out.

PREVIEW-Greek Jan inflation seen rising to 2.7 pct y/y

Greek CPI is seen rising further in January to an annual pace of 2.7 percent as favorable base effects from oil wane, economists said.

The median forecast of six economists surveyed by Reuters showed Greece's headline CPI rate picking up further after a rise to 2.6 percent in December.

The index dropped to a 41-year low of 0.5 percent in May and June.

On a monthly basis, inflation is seen falling 0.3 percent, mainly as a result of the winter sales.

Economists expect inflation to rise further to 2.8 percent in February and average out at 2.5 percent in 2010.

A rising inflation reading would not have a significant market impact in the short-term, as the market is already expecting an upward trend in Greek consumer prices.

But if consumer inflation exceeds market expectations -- and continues to do so in the second half of the year when analysts expect a deceleration -- that could jeopardize government efforts to freeze public sector wages in an effort to control the budget deficit.



DEEP DIVE Commentary and Analysis

U.S. problems may hurt dollar once euro pain fades

By Neal Kimberley

Fiscal fragility in the euro zone has contributed to the global uncertainty supporting the dollar but U.S. economic problems are too big to ignore and may undermine the greenback in the medium term.

In the market's current mood, even renewed signs of U.S. weakness would probably support the dollar in the short term, triggering safe-haven buying of the kind seen after Lehman Brothers collapsed in late 2008.

But looking further ahead, particularly if euro zone sovereign debt problems abate, evidence of U.S. economic frailty should weigh on the dollar. Its strength would be unsustainable.

Arguably a reversal in sentiment might favor the U.S. national interest. As it stands, a rising dollar will surely not sit well with President Barack Obama's State of the Union pledge to double U.S. exports within five years.

Consider budget deficits -- the factor that has plunged Greece, Portugal and other euro zone states into trouble.

European Central Bank President Jean-Claude Trichet said on Thursday that the euro zone's combined deficit is projected at around 6 percent in 2010.

Earlier in the week, President Barack Obama's budget proposal forecast a record \$1.56 trillion U.S. deficit in 2010, or 10.6 percent of GDP. Greece's fiscal deficit was 12.7 percent of GDP in 2009 and the prime minister said the government planned to cut it by four percentage points this year.

Perhaps even more tellingly, Obama's budget predicted U.S. public debt will rise as a proportion of GDP to above 71 percent in 2013 from 53 percent in 2009.

Ratings agency Moody's argued that if the U.S. economy grows anaemically, already stretched government finances could be adversely affected, potentially putting downward pressure on the U.S. triple-A rating.

U.S. Treasury Secretary Timothy Geithner was sufficiently roused as to dismiss the notion.

On the jobs front, the 20,000 job losses revealed in January's U.S. employment report disappointed. Moreover, there was an unusually large revision to payrolls showing job losses were considerably steeper than first thought.

The annual "benchmark revision" revised the level of employment for December 2009 down by 1.39 million, taking the number of jobs lost since the start of the recession to 8.4 million.

Also the apparent improvement in the unemployment rate to a five-month low of 9.7 percent deserves to be treated with caution, owing much to a sharp increase in the number of people giving up looking for work.

The U.S. housing market also gives cause for concern. Existing home sales fell in December. New home sales also declined.

FANNIE AND FREDDIE

It is also hard to ignore the continued woes of Fannie Mae and Freddie Mac. Obama's budget plan expects the two government sponsored entities, both still operating within conservatorship, to draw another \$69 billion from their Treasury credit line in fiscal 2010, while paying back \$12 billion.

But the uncertainties are not restricted to the federal level. Individual states continue to face challenges.

California, downgraded by Standard & Poors, might have to resort to the "shameful" practice of issuing IOUs or delaying payments if Golden State legislators do not act fast to close holes in the budget, state Controller John Chang warned on Jan. 22.

Nevada has an \$881 million state budget gap and Moody's revised Obama home state Hawaii's rating outlook to negative

from stable on Thursday.

As discussed above, traders surveying all these problems will likely still favor the dollar as a short term safe haven destination. But further ahead the dollar may have problems. Obama's exports pledge should not be forgotten.

In a competitive world when your hourly earnings rate is \$18.89 an hour, you do not double exports with a rising currency.

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

Euro zone bond frenzy echoes past battles

By Paul Taylor

The feeding frenzy in bond markets over highly-indebted southern euro zone states recalls the runs on European currencies in the 1990s before the euro was created.

European governments eventually saw off that challenge with a sustained display of political determination backed by central bank intervention to defend the European Monetary System.

Whether they can overcome the current panic about sovereign default risks in the single currency area by showing political resolve without mutual financial assistance remains to be seen.

Then as now, traders made money by probing perceived weak links in the EU, forcing the Italian lira and the British pound out of the Exchange Rate Mechanism in 1992 and repeatedly attacking the French franc.

Then as now, there were accusations that the attacks were driven by "Anglo-Saxon" speculators hostile to European monetary union. Markets went wild on Friday afternoon rumors of secret weekend meetings of European finance officials.

After a four-year battle that began in 1992 when Denmark rejected the Maastricht treaty in a referendum, political will eventually prevailed over market forces.

The last great challenge to the franc-deutschemark exchange rate at the heart of the ERM was repelled in 1995 once new French President Jacques Chirac had made clear his determination to pursue orthodox fiscal policies.

Today's debt crisis is both similar and very different. The mounting market frenzy feels eerily familiar.

It began with pressure on Greece, the country with the biggest public finance problems in the 16-nation euro area, but spread last week to Portugal and, to a lesser extent, Spain.

The premium that investors demand to hold Greek bonds rather than benchmark German Bunds narrowed on media reports or rumors of an imminent European bail-out, or of Chinese interest in Greek debt, only to widen further on official denials.

Each strike call, parliamentary setback or glitch in routine debt management triggered a new sell-off or an increase in the price of insuring sovereign debt against default on the highly speculative credit default swaps (CDS) market.

Seasoned market watchers say the gyrations are mainly the work of short-term speculators and do not reflect a fundamental rethink about euro-denominated assets.

"We don't see any fundamental moves at all. It's purely speculative," said Patrick Smith, senior investment manager at Santander Asset Management.

That speculation is easier because markets are still awash with cheap liquidity injected by the European Central Bank to avert a credit crunch during the financial crisis.

Borrowing money from the central bank at 1 percent and lending it to Greece at nearly 7 percent on sovereign bonds in solid euros ought to be a hugely attractive investment.

Yet big institutional investors are holding off, partly due to market volatility, but also because they want to see the Socialist government implement tougher public spending cuts.



DEEP DIVE Commentary and Analysis

"Greece in the long term is probably a good play but we have to wait for the government to see more signs on the expenditure side," said Jorgen Christian Hansen of Danish pension fund Unipension.

"The reason Greece is getting so much attention is that it is the first real test of the Euro-system in handling countries with excessive debt and too lax fiscal policies," he said.

EU governments will try to ride out the crisis without having to bail out Greece, or Portugal or Spain, by pressuring those countries to make draconian fiscal adjustments while declaring political support for them.

A single comment from Germany's finance minister a year ago that the euro zone would have to help if a member got into a serious situation was enough to calm market fever over Ireland.

The question is whether the EU can enforce budget discipline rules on peripheral euro zone states which its core members mostly failed to respect over the last decade. Compounding the problem, those countries have lost economic competitiveness,

and austerity will further slow their recovery from recession.

Euro zone countries cannot devalue their way out of trouble. The alternatives for Greece are to make painful and politically risky cuts in public spending, to seek a bail-out or to default.

Athens has to refinance 54 billion euros in public debt this year, 20 billion of it in the second quarter. It faces a crunch at the end of the year if Moody's joins two other credit ratings agencies in downgrading Greek debt below A grade.

Unless the ECB changes its mind, that would cut Greek banks off from central bank refinancing operations by disqualifying their government bonds as collateral. Analysts say that would trigger a chain reaction of bank defaults.

Outgoing EU Monetary Affairs Commissioner Joaquin Almunia shrugged off such disaster scenarios in a Jan. 29 Reuters interview, underlining to the fickleness of financial markets.

"You know the markets," he said. "On other occasions, they became nervous one day and receded a week afterwards. I'm sure they'll find something bigger to worry about soon."

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(Compiled by Anil Kumar and Pronita Naidu in Bangalore)

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