

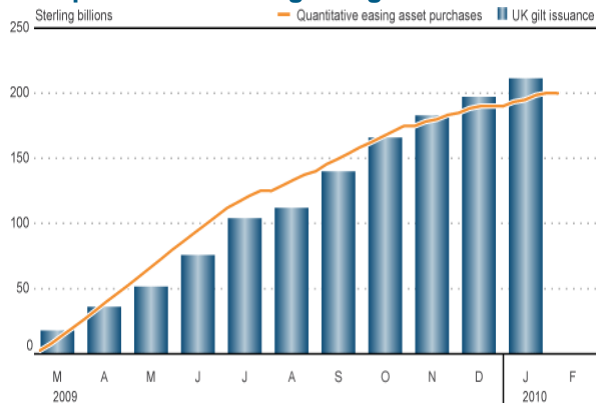
INSIDE DEBT

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Wednesday, February 10, 2010

CHART OF THE DAY

UK quantitative easing and gilt issuance



The Bank of England may have to pump more money into Britain's fragile economy, Governor Mervyn King said after the central bank forecast inflation would stand well below target in two years.

TODAY'S TOP NEWS

- Bernanke lays out vision for Fed monetary exit
- Euro zone in intense talks on Greek rescue
- U.S. trade gap widens in Dec to \$40.2 billion
- U.S. \$25 bln 10-yr auction draws poor demand
- BoE's King says far too soon to say QE is finished
- Freddie, Freddie unveil buyout plans
- Tax credits, Medicare fix in Senate jobs bill
- Global debt defaults hit record \$329 bln - Moody's
- Weak eurozone output points to anaemic Q4 growth
- China commodity trade slumps after December surge

ECON WATCH

FOR THURSDAY FEBRUARY 11

ET	Indicators	Unit	Reuters	Prior
02:00	DE Wholesale price ind mm	%	-	0.2
02:00	DE Wholesale price ind yy	%	-	0.2
08:30	CA New housing price index	%	0.4	0.4
08:30	US Initial Claims	k	465	480
08:30	US Jobless contin claims	mln	4.59	4.602
18:50	JP Foreign Bond Investment	bln	-	906.4
18:50	JP Foreign invest JP stock	bln	-	-32.9
00:00	JP Consumer confid. index	ind	-	37.6

MARKETS TODAY

TODAY'S TOP STORY: Federal Reserve Chairman Ben Bernanke detailed how the U.S. central bank will begin to wean the economy off its extraordinary stimulus, even as he stressed it was not yet time to do so.
For more please click here

TREASURIES: U.S. Treasuries fell after Federal Reserve Chairman Ben Bernanke outlined how the U.S. central bank would eventually reverse its loose monetary policy, and following a poor reception for the sale of benchmark notes.

- 10-yr Treasury prices were down 13/32 yielding 3.69 pct.
- 30-yr bond prices fell more than a point to yield 4.64 pct.
- 3-yr Treasury rose to 1.44 pct from 1.33 pct on Tuesday.
- 5-yr Treasury prices were down 8/32 to yield 2.37 pct.
- 2-yr notes fell 3/32 to yield 0.88 pct.

FOREX: The euro fell against the dollar, weighed down by uncertainty a day before a European Union summit about a possible bailout of debt-strapped Greece.

- Euro fell 0.46 pct to \$1.3727, after hitting a session low of \$1.3678. It fell 0.13 pct to 123.5 yen.
- Euro rose 0.39 pct to 88.10 pence.
- The dollar reversed losses against the yen at 89.95 yen, up 0.36 pct.
- Dollar index was up 0.26 pct to 80.069.
- Sterling shed 0.85 pct \$1.5579.

CORPORATES: Concern about European sovereign debt weighed on investor interest in U.S. high-yield bonds, amid concern about how Germany or other nations may support a bailout of Greece.

- The CDX.IG-13 index was steady at 102 bps.
- Fitch Ratings cut Berkshire Hathaway's investment-grade rating by two levels to AA-minus, due to Berkshire's acquisition of Burlington Northern Santa Fe Corporation.

STOCKS: U.S. stocks were little changed, recovering from morning losses after a report suggested a European rescue plan for debt-burdened Greece may be presented this week.

- Dow fell 0.2 pct to 10,038.38, S&P was down 0.22 pct to 1,068.13 and Nasdaq fell 0.14 pct to 2,147.87.
- Sprint Nextel Corp sank 7.95 pct to \$3.36 while Wyndham Worldwide Corp gained 4.71 pct to \$22.22.
- Walt Disney Co rose 0.64 pct to \$30.03.
- S&P financial index gained 0.82 pct, S&P auto index was down 1.7 pct, S&P material index shed 0.74 pct.
- KBW bank index rose 1.03 pct.

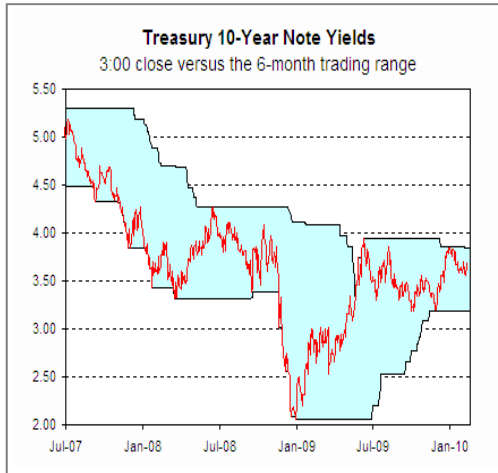
C & E: Oil rose above \$74 a barrel after the U.S. Energy Information Administration raised its forecast for crude demand and prices this year, a sign it expected economic recovery to gain steam.

- U.S. crude prices rose 0.99 pct to \$74.48, after dipping to \$72.60.
- Gold fell 0.46 pct to \$1,072.0 an ounce.
- Reuters-Jefferies index was up 0.42 pct to 266.23.

- 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	0.065	0.035	0.066	0.006
3-Mo Bill	0.105	0.095	0.106	0.002
6-Mo Bill	0.180	0.170	0.183	0.006
1-Year	0.363	0.355	0.369	0.034
2-Year	99.977	100.008	0.888	-0.102
3-Year	99.789	99.820	1.448	-0.184
5-Year	99.422	99.469	2.374	-0.266
7-Year	99.984	100.031	3.127	-0.258
10-Year	97.375	97.438	3.697	-0.406
30-Year	95.734	95.797	4.640	-0.867

EQUITIES

	INDEX	CHANGE
DJIA	10042.92	-15.87
NASDAQ	2149.16	-1.71
S&P 500	1068.81	-1.71

OIL

	PRICE	CHANGE
NYMEX	74.4	0.7
BRENT	72.4	0.3

EURODOLLAR FUTURES

	CLOSE	CHANGE
Feb-10	99.748	0.003
Mar-10	99.715	0.010
Jun-10	99.565	-0.010
Sep-10	99.305	-0.035

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.180	O/N	0.190
2-Week	0.200	2-Week	0.200
1-Month	0.200	1-Month	0.210
3-Month	0.220	3-Month	0.240
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.180	10:00 AM	0.110
2-Week	0.190	3:00 PM	0.108
1-Month	0.210		
3-Month	0.230		

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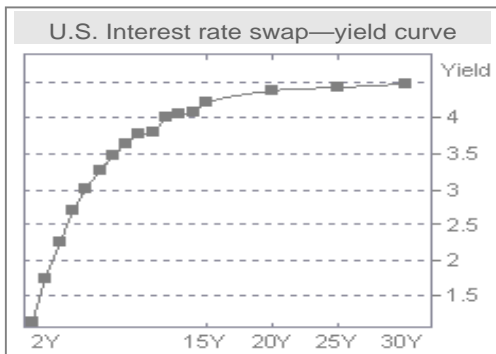
	SPREAD		RATE	
2-Year	27.25	31.25	1.15	1.18
3-Year	32.50	36.50	1.77	1.78
5-Year	32.00	36.00	2.69	2.69
7-Year	15.25	19.25	3.28	3.27
10-Year	9.00	13.00	3.78	3.77
30-Year	-15.75	-11.75	4.48	4.46

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.42	-0.27
CBOT 10 yr	117.91	-0.33
CBOT 30 yr	118.41	0.09

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.140	0.160	-	-
1-Month	0.180	0.280	0.128	0.138
3-Month	0.220	0.400	0.148	0.158
6-Month	0.250	0.450	0.184	0.194
12-Month	0.650	1.000	0.349	0.359



CURRENCIES

	BID	ASK
Euro	1.3740	1.3742
Sterling	1.5587	1.5592
JP Yen	89.90	89.92
Swiss Franc	1.0676	1.0678
Can Dollar	1.0613	1.0618
Mexico	13.0855	13.0916

FED FUNDS NYFRSM - 10AM

Open	0.1400	1m	0.2150
High	0.1500	3m	0.2469
Low	0.0900		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	0.875	12/01/2012	13 11	1.01
3-Year	1.375	09/01/2013	20 17.5	1.6
5-Year	2.875	09/02/2015	34 33.5	2.68
7-Year	5.125	18/10/2016	22.5 22	3.35
10-Year	-	-	- -	-
30-Year	6.625	15/11/2030	29.5 28.75	4.93

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1.125	15/12/2011	9.5 0	0.92
3-Year	1.75	22/02/2013	23.5 22.5	1.62
5-Year	2.625	20/11/2014	20.5 20	2.57
7-Year	5.25	15/09/2016	19 18.25	3.32
10-Year	3.75	27/03/2019	27 0	3.97
30-Year	6.25	15/07/2032	37.25 36.75	5.01

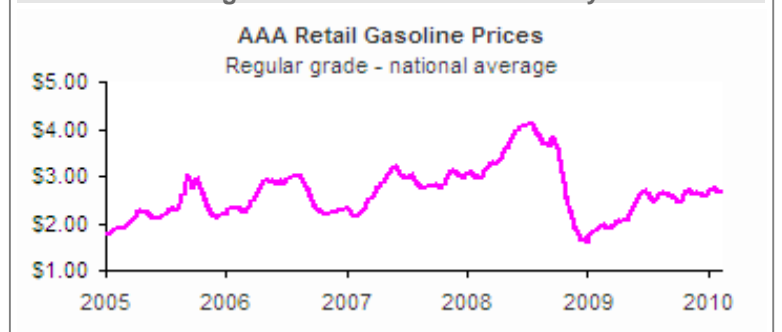
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.2010	105.2210	2.539
FHLMC	5.0	105.2210	105.2410	2.514

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	103.1670	103.1870	3.815
FHLMC	5.5	105.2460	105.2660	2.812
GNMA	5.5	106.0130	106.0330	3.446

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

Bernanke lays out vision for Fed monetary exit

Federal Reserve Chairman Ben Bernanke detailed how the U.S. central bank will begin to wean the economy off its extraordinary stimulus, even as he stressed it was not yet time to do so.

Bernanke said the Fed would likely begin tightening monetary policy by removing cash from the financial system before it turns to raise benchmark short-term interest rates.

In his most comprehensive description to date of how the Fed aims to dismantle its extensive emergency economic supports, he also said the central bank could soon raise the discount rate it charges banks for emergency loans, but stressed that would not be akin to a tightening in monetary policy.

Some lawmakers have worried the Fed's aggressive stimulus for the economy could spark inflation.

Separately, a top Fed official said, with the U.S. economy in the early stages of recovery, the Fed must find ways to withdraw unprecedented monetary accommodation without disrupting that progress. But to do so effectively, argued Dallas Fed President Richard Fisher, the central bank must retain independent oversight of monetary policy, which he said is currently under threat from several legislative proposals that could subject policymakers to "congressional second-guessing."

U.S. trade gap widens in Dec to \$40.2 billion

A big jump in oil imports swelled the U.S. December trade deficit to \$40.2 billion, an unexpected widening that suggested U.S. economic growth was not quite as strong as initially thought in the fourth quarter.

The Commerce Department's report, showing a 10.4 percent jump in the trade gap, came as both U.S. exports and imports recorded large gains for the month.

The trade report showed exports rose 3.3 percent in December to \$142.7 billion, the biggest percentage increase since March 2007 and the eighth consecutive monthly gain. But that was outpaced by a 4.8 percent rise in imports to \$182.9 billion.

The average price for imported oil rose to \$73.20 per barrel in December, which along with increased volume sent the monthly U.S. petroleum import bill to \$28.1 billion.

For the year, the U.S. trade deficit totaled \$380.7 billion, down 45.3 percent from 2008 in the biggest drop since 1991. It was also the smallest U.S. trade gap since 2002. U.S. exports fell a record 15 percent to \$1.55 trillion in 2009, while imports tumbled an even larger record 23.3 percent to \$1.93 trillion.

BoE's King says far too soon to say QE is finished

The BoE may have to pump more money into Britain's fragile economy, Governor Mervyn King said after the central bank forecast inflation would stand well below target in two years.

Presenting the BoE's quarterly Inflation Report, King said recovery would be slow with output below pre-crisis levels for some time to come. And that gloomy outlook did not even take into account the likelihood of fiscal policy being tightened hard after an election expected on May 6.

A Reuters poll showed most economists still think the BoE is done with buying mostly gilts with newly-created money, but now see only one 25 basis point interest rate hike this year.

While few analysts expect the BoE to expand its QE scheme again, King's comments make clear the MPC has not decided one way or the other.

Separately, British manufacturing output rose more than expected by 0.9 percent in December from an upwardly revised 0.2 percent in November, three times faster than economists had forecast, official data showed.

Euro zone in intense talks on Greek rescue

Euro zone countries held intensive talks on a possible rescue for debt-laden Greece as civil servants in Athens staged the first big strike against government austerity plans.

Financial markets gave Greece some respite with investors increasingly anticipating that other European governments, led by Germany and France, will help Athens head off any risk of a default that has shaken confidence in the euro.

Finance ministers of the Euro zone made no public comment after a meeting, but a European official said Eurogroup chairman Jean-Claude Juncker of Luxembourg would brief EU leaders on Thursday "on what can and cannot be done".

EU treaties bar euro zone member states from taking on each others' debts, complicating what would be the first bailout in the currency's 11-year history.

Euro area finance officials said bilateral aid by individual EU members, chiefly Germany and France, or guarantees for Greek debt issues appeared the most likely solution but they cautioned that no decision was imminent on the form of assistance.

U.S. \$25 bln 10-year auction draws poor demand

The U.S. government sold \$25 billion worth of 10-year debt in an auction that attracted poor demand amid a snow storm and rate hike jitters.

The auction was hampered by a snow storm that kept some traders out of their New York offices.

The 10-year offering attracted bids worth 2.67 times the amount on offer, which was near the average of 2.66 times in the 12 auctions over the last year.

However, yields came in above expectations based on trade in the when-issued market at the deadline, which indicated that investors were more aggressive than usual in pushing for lower prices and a yield premium to buy the bonds.

Demand from foreign central banks and large institutional investors was low, based on the indirect bidder category, which accounted for about 33 percent of the sale.

That was below the average of 42.2 percent in the auctions since June, which has become a benchmark for comparisons because changes in calculations boosted that category.

Direct bidding was a lone bright spot, coming in above average.

Freddie, Freddie unveil buyout plans

Freddie Mac and Fannie Mae each detailed plans to escalate buyouts of delinquent loans from their securities pools while Freddie Mac also skipped its February window to sell notes.

The plans provided clarity to a market eager for direction about the timing and pace of the buyouts, helping to narrow risk premiums, especially on higher-coupon mortgage bonds.

Freddie Mac said earlier that it would buy nearly all of the loans that are at least 120 days delinquent from its fixed-rate and adjustable-rate securities.

Fannie Mae later stated its intent to buy back loans that are at least delinquent for four straight months, starting in March and taking several months to complete a significant portion.

U.S. agency note spreads mostly narrowed slightly on Wednesday after Freddie Mac's decision to skip its February sale.

"We expect the impact on supply of Freddie Mac's plan to purchase 120-plus day delinquent loans out of trust to be marginal," Ryan Graf, RBS Securities analyst, said in a client note. For February, he put Freddie Mac's net funding needs are about \$600 million.

TODAY'S TOP NEWS

Tax credits, Medicare fix in Senate jobs bill

Highway funding and tax breaks for hiring workers figure prominently in a jobs-creation bill that Democrats and Republicans in the U.S. Senate hope will attract rare joint support in an election year, lawmakers said.

The bill, likely to be less costly and more bipartisan than the one passed by the House of Representatives, also extends unemployment benefits and postpones a scheduled 20 percent cut in payments to doctors under the Medicare health insurance program for the elderly.

The Senate legislation faces more than the usual procedural hurdles as a record snowstorm has paralyzed Washington and made it difficult for many lawmakers to get to work.

The Senate's top Republican, Minority Leader Mitch McConnell, said the jobs legislation would carry a price tag of roughly \$80 billion. That would be about half the size of the \$155 billion package that Democrats in the House passed in December with no Republican support. The bill would expand taxable bonds, known as "Build America Bonds," that help state and local government pay for big projects.

Global debt defaults hit record \$329 bln - Moody's

A record \$329 billion of corporate debt worldwide defaulted in 2009 as a protracted global recession sapped companies' ability to pay their debt, Moody's Investors Service said.

Defaults were up 17 percent from 2008, when they totaled \$281 billion, the previous record high, Moody's said in a report.

By comparison, the 2001-2002 bankruptcy wave, which included the massive failures of WorldCom and Enron, was responsible for just \$342 billion of defaults, versus \$610 billion during 2008-2009, according to Moody's data.

Top defaulters in 2009 included General Motors, with \$47.8 billion of debt, CIT Group Inc with \$42.3 billion, LyondellBasell's Lyondell Chemical with \$19.2 billion, and Charter Communications Operating LLC with \$10.8 billion, Moody's said.

Moody's has forecast that the global junk bond default rate will tumble to 3.3 percent by the fourth quarter from 13 percent at the end of 2009 as a global recovery takes hold.

Weak euro zone output points to anaemic Q4 growth

French and Italian industry output fell unexpectedly in December, following a plunge in German production, suggesting a nascent euro zone recovery lost momentum in the fourth quarter.

French factory output fell 0.1 percent month-on-month, INSEE said, also revising down November's rise to 0.6 percent from an initially reported 1.1 percent.

Italian seasonally adjusted industrial output was also much weaker than expected, falling 0.7 percent after a 0.4 percent rise the month before, statistics agency ISTAT said. Both figures were forecast to rise, by 0.5 and 0.1 percent respectively.

Today's figures chimed with data last week which showed German output fell sharply in December, by 2.6 percent on the month., dealing a fresh setback to recovery hopes in Europe's largest economy.

The euro zone is forecast to show quarterly growth of 0.3 percent, according to a Reuters poll of economists. Those estimates were gathered late last week after the poor German numbers but the Italian and French data skew risks to the downside.

China commodity trade slumps after December surge

China's commodity imports slumped in January after a surprising surge in December, as sea ice disrupted shipping and the country began to tighten monetary policy, spooking markets that had relied on its largesse in 2009.

For many copper traders, a fall of 20.9 percent in imports to 292,096 tonnes was a shock, as China had been expected to suck in more cargoes thanks to high local prices that allowed arbitrage trading.

Separately, Chinese exports rose strongly in January from a year earlier but tumbled from December, giving ammunition both to those who advocate a stronger yuan and those who say Beijing should play safe and keep its currency steady.

With the holiday falling in February this year, China effectively worked one extra week this January than in 2009 -- providing a springboard for a 21.0 percent rise in exports over the year-earlier month and a record 85.5 percent surge in imports.

NEXT UP

BoE seen less aggressive on rates but done with QE

The BoE will raise interest rates just 25 basis points in the final months of the year from a record low of 0.5 percent, slightly less than previously thought, a snap Reuters poll showed.

Median forecasts from the survey of over 50 economists, taken after the BoE published a downbeat set of growth and inflation forecasts, also saw the QE bond purchase program capped at 200 billion pounds.

The BoE's MPC is now expected to raise Bank Rate from its current record low of 0.5 percent to 0.75 percent in the fourth quarter, and then to 1.25 percent in the first three months of 2011, reaching 1.75 percent by June.

Those forecasts compare to a poll published on Tuesday which saw rates at 1.0 percent at the end of this year, 1.5 percent by March 2011 and 1.75 percent by June.

In the latest poll, analysts gave a median 55 percent chance rates would rise by the end of the year, with 33 of 52 seeing a policy rate rise by the end of the year. That is down significantly from 44 of 57 a poll published on Tuesday. Seven of 49 who answered the question saw the bank extending QE compared to just five of 60 in a poll taken at the end of last month.

OPEC sees slow recovery pressuring oil use

The slow pace of world economic recovery will put pressure on oil consumption this year, OPEC said in a report, which trimmed its 2010 global demand growth forecast.

The OPEC said in its monthly report that world oil demand would grow by 810,000 bpd in 2010, down 10,000 bpd from its previous forecast.

OPEC's report, the first of three closely watched oil outlooks due this week, adds to signs that the volatile economic recovery path is raising uncertainty over oil demand. Oil use in the United States, the world's top consumer, is the key risk to estimates this year, it said.

"The slow pace of the recovery in the world economy in 2010 is putting pressure on oil demand," the report from OPEC's Vienna headquarters said.

"Early assessment indicated that worse-than-expected U.S. oil demand might shave more than 100,000 bpd from the world oil demand growth forecast for 2010."

OPEC kept its oil output targets unchanged at a meeting in December, wrapping up a year of stable policy after making a record cut in its supplies in 2008 as recession eroded demand.



DEEP DIVE Commentary and Analysis

Greek aid would be no long-term fix for euro zone

By Brian Love

A possible European bailout of Greece could stabilize the euro zone's financial markets for now but would probably do little to ease investors' long-term concerns about economic tensions in the zone.

Euro zone countries were holding intensive talks on Wednesday about a possible rescue for Greece, whose debt crisis has dragged down the euro, regional banking stocks and many government bond prices this year.

But since news emerged from sources in Germany's ruling coalition on Tuesday that a rescue was on the cards, the euro has rallied only weakly from eight-month lows. It stood at \$1.3702 on Wednesday afternoon, almost unchanged from its level just before the German news.

Emergency aid to Greece, and conceivably Portugal and Spain, which are also struggling with debt, might involve debt guarantees, a bailout fund or other options.

Few analysts doubt that if they felt decisive action was urgently needed, the rich states of the EU could muster the financial strength to avert a funding crunch in the south of the zone this year.

Economists at the Bruegel economic think tank in Brussels have suggested that Greece might need emergency support in a range of 12-24 billion euros.

That is only about one or two tenths of a percentage point of the euro zone's gross domestic product last year; if Portugal and Spain were included in an aid package, costs would rise, but the fiscal plight of those countries does not appear as serious as Greece's so they would probably not require huge sums.

Therefore, if the EU's rich states overcome political and legal obstacles and announce a clear, detailed support package for Greece, euro zone markets can be expected to stage a quick, sharp rebound.

In anticipation of this, the spread of the 10-year Greek government bond yield over the benchmark German yield narrowed dramatically to about 285 basis points on Wednesday from around 320 bps on Tuesday. It was well down from last month's peak of 405 bps.

DOUBTS

But the spread remained far from the levels below 100 bps seen for relatively healthy countries in the north of the zone.

One reason for this is concern that any bailout of Greece could actually lead to more fiscal problems down the road.

The EU has been pressing Athens hard to cut its budget deficit with austerity measures; if Greece were now given aid, domestic political pressure to take those steps might weaken.

Conditions could be attached to the aid, but it is unclear whether the EU, whose members have repeatedly broken budget rules for years, could threaten sanctions harsh enough to compel fiscal discipline. The EU would almost certainly shy away from the harshest sanction, expelling Greece from the euro zone.

Also worrying the markets is the risk that a rescue of Greece, which would be the first such bailout in the euro zone's 11-year history, could set a precedent: the zone's most powerful member, Germany, might end up having to support weaker states for years.

So far, the spreads of German bonds against U.S. Treasuries have not been seriously affected by the Greek crisis. But that might change if it started to appear that Germany had to assume an extended commitment to Greece.

"Unfortunately, the price of this in the shorter term -- six months, 12 months, two years, who knows -- is a re-evaluation of Germany by investors," said Simon Derrick, a currency investment

strategist at Bank of New York Mellon.

"In the long run, confidence will return, especially if Germany starts cracking the whip, but first they need to deal with the problems in Europe as they currently stand."

ECONOMIC STRAINS

Another source of worry is the diverging economic performances between euro zone powerhouses such as Germany and the weaker countries such as Greece -- divergences that any bailout would probably do little to change.

A European Commission report last month found the real effective exchange rate for Greece, Spain and Portugal was overvalued by more than 10 percent -- an indication of how much wages there would have to fall, or productivity rise, to make those countries competitive within the euro zone.

"The persistence of large cross-country differences jeopardises confidence in the euro and threatens the cohesiveness of the euro area," the EC said.

Austerity measures could narrow those differences over a period of years. But to address the root cause of imbalances within the euro zone, Germany might have to shift its export-led economic model more towards domestic consumption, which would be challenging politically.

"Unless these questions are answered, we still face the prospect of a less dynamic, more debt-ridden euro zone, which equates to a sell recommendation on the euro," said Marco Annunziata, chief economist at UniCredit bank in London.

REFORMS

The Greek crisis could conceivably benefit the euro zone in the long run if it prompts the group to reform its management -- by, for example, giving Brussels new powers to monitor statistical data from the zone's members -- and to coordinate the economic policies of individual states more closely.

So far, however, there is little sign of this happening, partly because the zone has become so large and unwieldy, and partly because countries such as Germany fear any loss of sovereignty over economic policy.

German Chancellor Angela Merkel has made it clear she blames the fragmentation of the euro zone economy not on weaknesses in the EU treaty underlying it, but simply on the failure of certain member states to respect the rules.

Another reason not to expect the Greek crisis to lead to reform is that, for the moment at least, the weakness of the euro caused by the crisis is probably welcome to some states. Countries including France have complained since last year that a strong euro was hurting their exporters.

"If the cost of preserving political union is a weaker currency over time, then perhaps this isn't that great a cost to bear. At least the French will be happy," said Derrick.

Gold bull run set for breather as rate hikes eyed

By Jan Harvey

Gold's decade-long bull run may plateau in the medium term as a rise in U.S. interest rates from record lows makes prices vulnerable to a dollar recovery and weaker investment demand.

While fears over the stability of paper currencies and inflation may keep gold high, it will struggle to maintain the soaring investment flows that took it to an all-time peak of \$1,226.10 an ounce in December, analysts say.

In the short term, gold's underlying fundamentals look fragile as jewellery demand languishes and miners lift supply. Spot prices had retreated from their December highs to around \$1,076.50 an ounce by early afternoon on Wednesday.

"We see a number of headwinds for investors in gold, most no-



DEEP DIVE Commentary and Analysis

tably potential increases in rates," said RBS Global Banking & Markets analyst Daniel Major. "The opportunity cost of investing in commodities is going to be important."

"RBS currency strategists are forecasting further strength in the dollar against the euro and potential rate hikes in the second half of next year," he added. "Both of those are potentially negative factors for gold investment."

Gold's bull run since early 2001 has gone hand-in-hand with dollar weakness, but the U.S. unit has firmed since December as fears over rising euro zone debt levels knocked the euro.

But moves in U.S. interest rates from current record lows will be the main driver of the dollar, and consequently gold.

A Reuters poll released earlier this week showed primary dealers believe the U.S. Federal Reserve will start lifting rates in the fourth quarter of 2010.

While gold may be able to shrug off a rebound in the dollar if other factors emerge, analysts are sceptical it will make significant new gains in such an environment.

"You can be a gold bull and still believe in rising interest rates if you believe in inflation, which a lot of gold bulls do," said Daniel Sacks, a portfolio manager at Investec Asset Management. "We're not convinced."

"You can see the point that a huge increase in money supply, you'd think, would cross over into inflation, but it is not clear whether that mechanism will hold or not."

DEMAND UNCERTAIN, SUPPLY SEEN RISING

Gold's gains have also been boosted by limits on official sector sales and, more recently, central bank buying.

India bought 200 tonnes of gold late in 2009, and news of heavy Chinese buying broke earlier in the year. But analysts say more central bank buying is unlikely at elevated prices levels.

Gold miners' buy-backs of forward sales are also unlikely to remain a significant source of demand as only one large miner, AngloGold Ashanti, still holds significant hedge positions.

Miners are responding to rising prices by upping production.

In December the world's biggest miner Barrick Gold, said its output should continue to trend higher past 2010, while number two gold miner Newmont Mining said it sees output climbing 5-10 percent this year.

"High prices have massively incentivised additional exploration, and there are a lot of new gold mines coming on stream," said Natixis analyst Nic Brown. "We see supply increasingly substantially in the immediate years ahead."

Jewellery consumption, which typically makes up two-thirds of global demand, fell 23 percent last year as high prices put off buyers, data from the World Gold Council showed.

While this was outweighed by a sharp rise in investment demand, a retreat in holdings of gold-backed exchange-traded funds in the early weeks of the year is worrying analysts.

There is however a significant upside risk to prices. Further worries over broad-based currency devaluation based on lingering instability in the financial markets could see interest in gold rise as an alternative store of value.

"Every currency in the western world is being devalued," said Eddington Asset Management's chief investment officer Alex Allen. "Therefore gold has some kind of value to investors."

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