

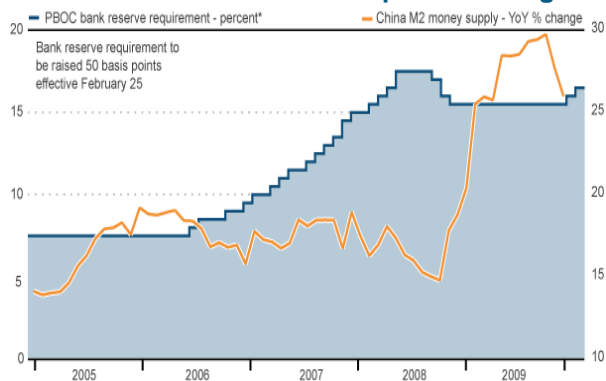
INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Friday, February 12, 2010

CHART OF THE DAY

China lifts banks' reserve requirements again



With the reserve requirement increase, China's biggest banks will now have to put 16.5 percent of their deposits on hold at the central bank, crimping their ability to lend.

TODAY'S TOP NEWS

- China surprises by raising banks required reserves
- Greek slump threatens debt plan, EU aid elusive
- Obama signs debt limit-paygo bill into law
- U.S. retail sales rise brightens recovery picture
- Republican Gregg sees scope on financial regulation
- Dubai CDS jump, bonds selloff on debt uncertainty
- **For more stories please click here**

ECON WATCH

FOR MONDAY FEBRUARY 15

ET	Indicators	Unit	Reuters	Prior
-	US President's Day	-	All markets closed	
-	CA Family Day	-	Market holiday	

ECON WATCH

FOR TUESDAY FEBRUARY 16

ET	Indicators	Unit	Reuters	Prior
04:30	GB CPI mm	%	-0.1	0.6
04:30	GB CPI yy	%	3.5	2.9
04:30	GB RPI mm	%	0.0	0.6
04:30	GB RPI yy	%	3.8	2.4
04:30	GB RPI-X mm	%	0.1	0.6
04:30	GB RPI-X yy	%	4.7	3.8
05:00	DE ZEW economic sent.	ind	42.0	47.2
05:00	DE ZEW current conditions	ind	-52.8	-56.6
08:30	US NY Fed manufacturing	ind	18.0	15.92
09:00	US Net L-T flows, exswaps	bln	-	126.8
09:00	US Foreign buying, T-bonds	bln	-	118.3
13:00	US NAHB housing mkt indx	ind	16	15

MARKETS TODAY

TODAY'S TOP STORY: China raised the level of reserves banks must hold for the second time this year, spooking financial markets, raising fears about a global economic recovery and denting investors' appetite for risk. **For more please click here**

TREASURIES: U.S. Treasury prices rose as renewed uncertainty over the fate of debt-laden conglomerate Dubai World and China's move to curb lending boosted the appeal of safe government debt.

- 30-yr and 10-yr Treasury prices were up yielding 4.65 pct and 3.69 pct respectively.
- 5-yr Treasury prices rose 5/32 to yield 2.33 pct, down from 2.37 pct.
- 2-yr notes rose 3/32 to yield 0.83 pct.

FOREX: The euro fell to a nearly nine-month low against the U.S. dollar as questions persisted about a rescue deal for debt-stricken Greece, while higher-yielding currencies weakened after China unexpectedly raised bank reserves.

- Euro fell 0.57 pct to \$1.3615, after dropping to \$1.3533, its weakest level since May 2009.
- The dollar index rose to 80.322, the highest since July 2009.
- Euro fell 0.24 pct to 122.57 yen and was low against the Australian dollar at A\$1.5352.
- The dollar rose 0.3 pct to 90.01 yen and was up 0.15 pct against the sterling to \$1.5678.

CORPORATES: U.S. corporate bonds were mixed, with spreads on higher-quality names steady while the rest of the market widened on weak consumer sentiment data and ongoing concerns over sovereign risk.

- The CDX.IG-13 index widened by about 1 bps to 99 bps.
- Dubai CDS traded as high as 660 bps at one stage, but CMA DataVision said they were quoted around 640 bps.
- S&P raised its corporate credit rating on Amazon.com higher into investment-grade territory and changed its outlook to positive.

STOCKS: The Dow and S&P 500 dipped as China's move to curb bank lending and economic data both in the U.S. and abroad stoked fears that the global economic recovery might be in jeopardy.

- Dow shed 0.46 pct to 10,097.18, S&P fell 0.28 pct to 1,075.49 and Nasdaq was up 0.28 pct to 2,183.53.
- Shares of Alcoa Inc dropped by 2.21 pct to \$13.28 while United Technologies Corp shed 1.53 pct to \$65.69.
- GE shares were down 1.4 pct to \$15.55 and RIM rose 3.12 pct to \$71.33. Ingersoll-Rand Plc shed 7.81 pct to \$31.26.

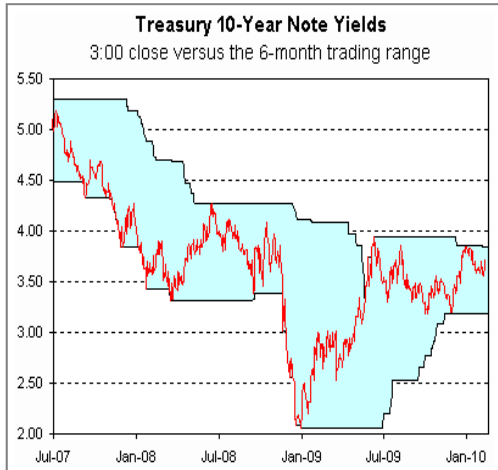
C & E: Oil fell more than a dollar to \$74 a barrel, weighed down by rising U.S. crude inventories and concerns that China's unexpected move to lift bank reserve requirements could slow commodity demand in the world's No. 2 fuel consumer.

- U.S. crude prices shed 1.43 pct to \$74.2.
- Gold was down 0.27 pct to \$1,092.85 an ounce.
- Reuters-Jefferies index fell 0.66 pct at 267.92.

- **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	0.055	0.020	0.056	-0.003
3-Mo Bill	0.100	0.085	0.101	0.001
6-Mo Bill	0.170	0.165	0.173	-0.007
1-Year	0.340	0.320	0.346	-0.018
2-Year	100.078	100.109	0.835	0.078
3-Year	99.961	99.992	1.389	0.133
5-Year	99.609	99.648	2.334	0.160
7-Year	100.156	100.203	3.100	0.242
10-Year	99.453	99.500	3.691	0.266
30-Year	99.531	99.594	4.654	0.309

EQUITIES

	INDEX	CHANGE
DJIA	10073.98	-70.06
NASDAQ	2177.88	0.47
S&P 500	1073.04	-5.43

OIL

	PRICE	CHANGE
NYMEX	74.1	-1.2
BRENT	72.9	-1.2

EURODOLLAR FUTURES

	CLOSE	CHANGE
Feb-10	99.748	0.000
Mar-10	99.710	0.000
Jun-10	99.585	0.015
Sep-10	99.350	0.040

REPURCHASE AGREEMENTS

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

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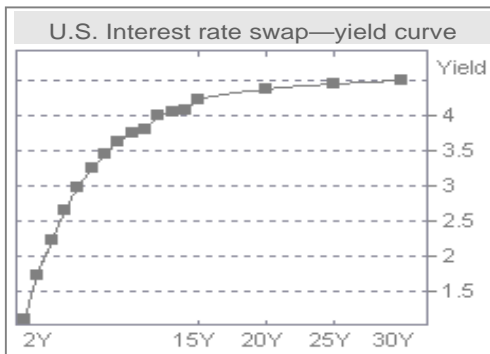
	SPREAD		RATE	
2-Year	27.25	31.25	1.10	1.13
3-Year	32.75	36.75	1.71	1.73
5-Year	31.75	35.75	2.65	2.65
7-Year	15.25	19.25	3.25	3.24
10-Year	7.75	11.75	3.77	3.75
30-Year	-16.00	-12.00	4.49	4.47

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.61	0.20
CBOT 10 yr	118.08	0.31
CBOT 30 yr	117.47	0.34

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.130	0.150	-	-
1-Month	0.180	0.280	0.122	0.132
3-Month	0.220	0.400	0.144	0.154
6-Month	0.250	0.450	0.170	0.180
12-Month	0.650	1.000	0.320	0.330



CURRENCIES

	BID	ASK
Euro	1.3612	1.3614
Sterling	1.5665	1.5670
JP Yen	89.95	89.98
Swiss Franc	1.0771	1.0774
Can Dollar	1.0505	1.0510
Mexico	12.9398	12.9478

FED FUNDS NYFRSM - 10AM

Open	0.1300	1m	0.2200
High	0.1400	3m	0.2494
Low	0.0800		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	11.5	10.5	0.94
3-Year	1.375	09/01/2013	17	0	1.55
5-Year	2.875	09/02/2015	33.5	32.5	2.69
7-Year	5.125	18/10/2016	27	0	3.39
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	0	31	-

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	6.5	5	0.9
3-Year	1.75	22/02/2013	22.5	21.5	1.61
5-Year	2.625	20/11/2014	19.5	19	2.52
7-Year	5.25	15/09/2016	25.75	25	3.36
10-Year	3.75	27/03/2019	25	24	3.93
30-Year	6.25	15/07/2032	37.5	0	5.02

Active MBS 15YR

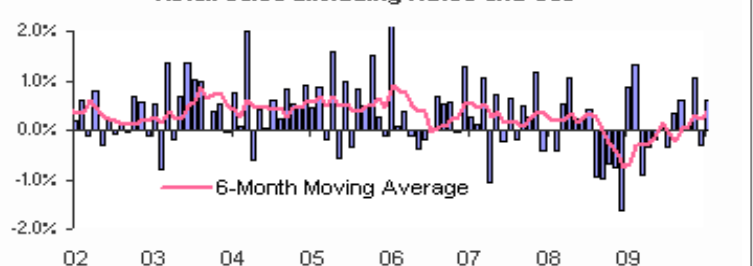
	CPN	BID	ASK	YIELD
FNMA	5.0	105.1910	105.2110	2.552
FHLMC	5.0	105.1910	105.2110	2.552

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.1260	105.1460	3.001
FHLMC	5.5	105.1950	105.2150	2.863
GNMA	5.5	106.0020	106.0220	3.457

Wrightson ICAPSM Chart of the Day

Retail Sales Excluding Autos and Gas



TODAY'S TOP NEWS

China surprises by raising banks required reserves

China raised the level of reserves banks must hold for the second time this year, spooking financial markets, raising fears about a global economic recovery and denting investors' appetite for risk.

China increased its reserve level for banks by 50 basis points on the eve of its New Year's holiday in a move aimed at slowing lending and tempering inflation.

Although investors had been expecting the People's Bank of China to push the reserve requirement ratio higher after an increase last month, few thought the second rise would come so soon.

This week's data also showed that, for all the government's insistence that banks control their pace of lending, Beijing has still been struggling to rein in credit. Banks lent 1.39 trillion yuan (\$203.4 billion) in January, the third-largest monthly total on record.

With the reserve requirement increase, China's biggest banks will now have to put 16.5 percent of their deposits on hold at the central bank, crimping their ability to lend.

The 50 basis point rise, which comes into force on Feb. 25 after the New Year's holiday, will drain about 300 billion yuan.

Economists polled by Reuters expect the central bank to raise benchmark interest rates in the second quarter, following with a second rate rise later in the year.

Obama signs debt limit-paygo bill into law

President Barack Obama signed a law lifting the U.S. government's borrowing authority to \$14.3 trillion and installing a pay-as-you-go rule to curb spending, the White House said.

The U.S. House of Representatives passed the debt limit bill last week, giving it final congressional approval and sending it to the White House for Obama's signature.

The U.S. Treasury was expected within weeks to exceed the current \$12.4 trillion government debt limit set in December. Failure to raise the limit would roil financial markets.

The bill also contained 'pay-as-you-go' legislation that requires new spending to be offset with cuts elsewhere.

Democrats, who control the U.S. Congress, crafted the "paygo" language to deflect voter anger over soaring spending and to show they are serious about fiscal responsibility. They say paygo rules helped the country turn budget deficits into surpluses in the 1990s.

Republican Gregg sees scope on financial regulation

Republicans and Democrats in the U.S. Senate share common ground on financial regulation, but the White House's stance on how to protect consumers from banking abuses remains an obstacle to legislation, a top Republican senator said.

Sen. Judd Gregg of New Hampshire, ranking Republican on the Senate Budget Committee, said in a television interview that the need for financial regulation was so widely recognized in Congress that he believes lawmakers will produce a bipartisan measure.

"There's a lot of common ground here. This really isn't a partisan issue," Gregg told CNBC. "This is an extremely complex exercise in getting governance right and the only really big philosophical difference here is how you protect consumers."

A leading Wall Street money manager warned that uncertainty combined with angry Washington rhetoric toward Wall Street could jeopardize the U.S. economic recovery by causing banks to cut back on the lending to small and mid-size businesses.

Greek slump threatens debt plan, EU aid elusive

Greece's economy shrank more than feared last quarter and the government sharply revised down its figures for the previous three quarters as well, increasing doubts about its ability to resolve its debt crisis.

A European Union government source said meetings of the region's finance ministers next week were unlikely to put together an aid package for Greece, suggesting governments were still unable to decide how to prevent the crisis from hurting financial markets' faith in the euro zone.

Greece's debt problems are hitting the syndicated loan market and could increase the cost of borrowing for Greek companies, which have \$34 billion of loans outstanding.

Bids on Europe's top 40 leveraged loans fell to 90.57 percent of face value, down 68 basis points in the last two weeks as loans showed increased correlation to the equity and Credit Default Swap markets, according to TRLPC data.

Separately, German Chancellor Angela Merkel resisted a quick bailout of Greece at a summit that failed to offer concrete proposals to help the country tackle its debt crisis, a British newspaper reported.

U.S. retail sales rise brightens recovery picture

Sales at U.S. retailers were unexpectedly strong last month, suggesting consumers were feeling a little more comfortable to spend and improving prospects for first-quarter economic growth.

Retail sales rose 0.5 percent as consumers stepped up spending not only on essential goods but luxury items as well, the Commerce Department said. Core retail sales rose 0.8 percent after falling 0.3 percent in December.

A separate report on consumer confidence showed worries over unemployment were weighing on sentiment, the slight slip left intact a longer-term trend toward improvement.

The Reuters/U-Mich Surveys of Consumers' index of sentiment came in at 73.7 for February, down from 74.4 in late January but up from 56.3 a year ago. Analysts had expected a rise to 75.0. A second report from the Commerce Department showed U.S. business inventories slipped 0.2 percent in December after rising 0.5 percent in November.

Dubai CDS jump, bonds selloff on debt uncertainty

Dubai debt insurance costs surged to 2-1/2 month highs and bond yields rose as growing uncertainty over the fate of the debt-laden conglomerate Dubai World sent investors scrambling to hedge their exposure.

The five-year 2014 bond issued last November by the Dubai Department of Finance sold off heavily, falling 2 points to a record low 86.5. The yield rose half a percent to about 10 percent according to Reuters data.

Dubai CDS traded as high as 660 basis points at one stage but CMA DataVision said they were quoted around 640 bps by 1515 GMT. That is the highest level since November when Dubai asked creditors for a standstill on some \$22 billion of state-run Dubai World's debt. A banker familiar with Dubai debt markets have also generally been jittery following the publication of an article in al-Itihad newspaper quoted sources as saying Dubai World would ask creditors for a six-month debt standstill.

Effective from end-February that would cover \$980 million payment of a Nakheel floating rate note due in May.

Banking sources told Reuters earlier this week that the Limitless loan-- syndicated by 18 banks from the Middle east, Asia and Europe -- would be rolled over.



TODAY'S TOP NEWS

W.House sees support for Sen Reid's jobs bill

White House spokesman Robert Gibbs said he believes a scaled-back jobs bill proposed by Senate Majority Leader Harry Reid can win bipartisan support in the Senate.

Reid has drawn fire from some on Capitol Hill for offering a much-smaller jobs bill by pulling four key provisions from a bigger bill proposed by Senate Finance Committee Chairman Max Baucus and his Republican counterpart, Charles Grassley.

Gibbs said he believes Reid's bill "will garner bipartisan support." Obama is to campaign in Las Vegas next Friday with Reid, who faces a difficult re-election battle.

Gibbs also said President Barack Obama still believes a consumer protection agency is a top goal. Such an agency has been tied up in financial regulation reform legislation that has yet to be passed. "In terms of the consumer office, the president still believes it's a great priority to have the independent authority to ensure that consumers in this reform are protected."

Fitch survey highlights bank hybrid uncertainty

Regulatory uncertainty could dampen the sale of hybrid bonds by banks this year, with a majority of European fixed income investors expecting only moderate issuance, according to a Fitch Ratings survey.

A lack of regulatory clarity over what types of bonds they can issue could also deter banks from redeeming these securities at their first maturity or "call" dates.

Some 55 percent of European credit investors surveyed by Fitch expected a "moderate" issuance of these hybrid bonds, which combine characteristics of debt and equity. Nine percent of the investors surveyed expected a "significant volume".

New rules on hybrid bonds are under discussion by international financial regulators, including the Basel Committee on Banking Supervision. In the meantime, Fitch said banks might continue to issue old-style hybrids, which could still count towards their capital under a "grandfathering scheme".

German halt, Italian reverse hit euro zone recovery

Europe's post-recession recovery hit a roadblock as German economic growth unexpectedly halted and Italy went into reverse in the final quarter of 2009, knocking total euro zone GDP growth almost flat.

GDP in the euro zone came in just 0.1 percent higher than the previous quarter, below the 0.3 percent forecast and well short of the 0.4 rise that lifted it from recession in the third quarter. Euro zone GDP dropped 4.0 percent in 2009 as a whole.

German quarter-on-quarter growth was zero after expansions in the two previous quarters that ended a year-long recession. Growth of 0.2 percent had been forecast.

Italy did even worse with a GDP fall of 0.2 percent from the third quarter, contrary to forecasts that the euro zone's third largest economy would keep its head above water with a 0.1 percent increase.

BoE's King says UK, U.S. closer than EU on regulation

Britain and the United States are more convinced of the need to force banks to hold more capital than some big European nations, Bank of England Governor Mervyn King told the Council for Financial Stability last month.

The minutes of the first formal quarterly meeting of the new body -- made up of the BoE, the Treasury and the Financial Services Authority -- on Jan. 14, published today, showed King felt the task of getting nations to agree to stricter rules for banks "should not be underestimated".

FSA Chairman Adair Turner told the meeting that, while Britain had pushed hard to implement internationally agreed standards for remuneration in the financial sector, others were dragging their feet.

Policymakers worry that different approaches to regulation across the world will encourage banks to take advantage by shifting their operations to less strict jurisdictions and, in doing so, create pockets of risk across the global system.

NEXT UP

Greek crisis, rates outlook dominate

Investors will seek further clarity on the Greek aid package next week when they will also assess the prospect of prolonged low interest rates in the developed world as the euro debt crisis forces fiscal austerity.

Investors, disappointed by a vague pledge by euro zone leaders to help Greece, are looking for greater detail from the meeting of the 16-nation bloc's finance ministers next week.

The unexpectedly rapid flare-up in the debt crisis and the threat of contagion to other highly indebted countries are forcing governments to tighten their finances and unwind fiscal support, leaving major central banks to singlehandedly aid the economy with low interest rates. Next week's inflation data and central bank minutes from U.S. and Britain will shed more light onto the timing of monetary exits after the Federal Reserve detailed how it would begin to unwind its extraordinary stimulus.

But the question now is whether central banks, especially the ECB, could raise interest rates at all this year.

U.S. economists see growth slowing end 2010-Fed survey

Private-sector economists see the economy growing more quickly than previously forecast in the first three quarters of

2010, but growth would be slower than expected toward the end of the year, a Federal Reserve Bank of Philadelphia survey showed.

For the full year 2010, economists raised growth estimates for annualized real GDP to 3 percent from their earlier projections of 2.4 percent. They said job growth would be greater than expected for the next two quarters, but downwardly revised estimates for after that. While jobs are now expected to grow by 600 a month in the first quarter and 117,600 a month in the second quarter, they are forecast to grow on average by 96,000 in the second half of 2010.

German investor morale seen falling for fifth month

Recent economic indicators have suggested the recovery in Europe's largest economy will be bumpy and will likely weigh on investor and analyst sentiment. According to Reuters polls, ZEW economic sentiment seen falling for the fifth month to 42.0 in February from 47.2, producer prices seen rising to 0.30 percent month-on-month in January, service flash PMI seen rising to 52.4 in February from 52.2 and manufacturing flash PMI seen edging up to 53.9 from 53.7. A stronger-than-expected fall in analyst and investor sentiment could dent hopes for a solid recovery in Germany and support Bund futures.



DEEP DIVE Commentary and Analysis

FED FOCUS-Exit toolkit comes without instruction manual

By Pedro Nicolaci da Costa

The U.S. Federal Reserve has the tools to withdraw the more than \$1 trillion it has pumped into the financial system but it's not clear policymakers are exactly sure how to use them.

Figuring out where to set benchmark interest rates, the Fed's usual lever to conduct policy, is already a tough judgment call. Now, a new array of options ranging from withdrawing short-term capital to selling longer-dated assets has made the machinery of policy even more complex.

That means adequate calibration, already a delicate act for Fed officials, will become all the more tricky. Unorthodox measures will require an unconventional exit and the central bank will have to learn by doing, with all of the potential for market disruption -- and inflation -- this entails.

"There is going to be considerable event risk, simply because we're in uncharted terrain," said economist Joseph Brusuelas of Brusuelas Analytics.

Fed Chairman Ben Bernanke on Wednesday laid out his most detailed vision yet of the central bank's path away from extraordinary stimulus measures. Still, plenty of uncertainty remains surrounding the implementation of such steps.

Bernanke and others at the Fed's Washington-based Board of Governors favor using the interest the Fed is now allowed to pay on banks' excess reserves, in addition to reverse repurchase agreements and term deposits, to induce market participants to park short-term dollars at the central bank.

In a reverse repo, the Fed agrees to sell securities such as Treasury bonds to investors for a short period and then buy them back at a slightly higher rate at a later date, allowing it to remove some money out of circulation for a time. Term deposits would give banks the incentive to leave money at the Fed for longer periods, probably ranging from one to six months.

BIG UNKNOWNNS

However, some officials, especially regional bank presidents, are uncomfortable with the current composition of the central bank's balance sheet, particularly the increasing proportion of mortgage assets resulting from its ongoing purchase of \$1.25 trillion in mortgage-linked bonds.

St. Louis Federal Reserve Bank President James Bullard told Reuters this week he would prefer to see the central bank begin to sell off assets before it raises interest rates -- perhaps as early as the second half of this year.

Richard Fisher, of the Dallas Fed, has been less explicit about his views on the sequencing of exit steps, but equally vocal about what he sees as the potential dangers of the Fed's asset purchases.

"We are constantly discussing internally the ways and means to shrink our balance sheet back to historical norms, aiming to have our holdings once again consisting primarily of Treasuries needed for the regular operations we undertake as the nation's central bank," Fisher said in a speech on Wednesday.

Investors also have their share of concerns.

Will attracting demand for term deposits be an issue, and would it strip demand for other short-term instruments like Treasury bills?

Will there be enough market demand for reserve draining operations, particularly from institutions like big money market funds that are flush enough with short-term cash to participate?

"That is one of the big unknowns," said Ian Lyngen, senior government bond trader at CRT Capital Group. "If the Fed is able to engineer the reverse repos in such a way that it can access money market mutual funds, that's going to allow them to really make strides in sopping up the excess liquidity."

Any failure of these tools could lead to a loss of confidence in the markets about the Fed's ability to retreat in a timely fashion. That could push up expectations of future inflation.

It might also complicate the Fed's ability to tighten financial conditions as it sees fit, and avoid an unwanted spike in inflation once the economy recovers more fully.

ANALYSIS-U.S. junk bond rally fizzles but some see value

By Dena Aubin

U.S. junk bonds are having their worst month since a massive rally started about a year ago, but market veterans are viewing the sell-off as a temporary setback.

With a sovereign debt crisis souring investors' appetite for risky assets, junk or high-yield bonds have posted a loss of 1.58 percent month to date, already their worst monthly performance since February 2009, when they were down 3.47 percent for the full month, according to Merrill Lynch data.

Yield spreads, which had dipped to 599 basis points over Treasuries on Jan 11, have widened to 693 basis points, according to Merrill data.

"Spillover from the sovereign risk concerns really seem to be the driving factor," said Marty Fridson, chief executive of Fridson Investment Advisors in New York, during a televised interview with Reuters Insider on Thursday.

"I would say that the high-yield market is now offering good value," Fridson said later in an un-televised interview. Over the next 12 months, "the return potential is comfortably in the low teens," he said.

High-yield bonds posted a record 57.5 percent investment return last year as a healing of the global credit crisis and recession helped risky assets rebound from a steep sell-off in 2008.

ECONOMIC CONCERNS WEIGH

After last year's run, the market has less upside, however, which means "you have to accept that we're going to have volatility this year," Fridson said.

Heavy new issuance, coupled with fresh concerns about the economic recovery, have also weighed on high-yield bonds in recent days, strategists said.

"In general the markets' appetite for risk has taken a step back, and I think that's probably temporary, but that's what's occurred across asset classes," said Kenneth Monaghan, head of high-yield credit and portfolio manager at Rogge Global Partners in New York.

While sovereign risk has been one trigger, "there's certainly concerns as well about employment levels and a whole host of other factors facing the economy," he said.

However, high-yield bonds, in particular better quality bonds, or those with double-B and single-B ratings, are still trading at relatively attractive yield spreads for this point in the economic cycle, Monaghan said.

Concern over rising debt in Greece and other euro zone countries undermined appetite for risky assets, including stocks, in recent weeks. The Dow Jones industrial average closed below 10,000 on Monday for the first time since November, though it has since rebounded on reports of an aid package for Greece.

Adding to investor jitters, a survey published on Wednesday showed a new index using truck stop fuel purchases to gauge future U.S. economic activity slumped in January, suggesting a slow economic recovery.

DEFAULTS HEADED LOWER

One reason high-yield investors are so nervous about the economy is that many highly leveraged borrowers are counting on a robust recovery to lift cash flows and allow them to deleverage



DEEP DIVE Commentary and Analysis

their balance sheets, said Christopher Munck, high-yield trader at B. Riley & co in Los Angeles.

If that does not happen, "the second half of 2010 could be a little dicey," he said.

The high-yield market may have "gotten ahead of itself" when spreads hit their lows in January, Fridson said.

At a spread of 693 basis points over Treasuries, however, high-yield investors are "very well covered, unless you do subscribe to the double-dip recession scenario," he said.

One gauge of high-yield's value is that spreads are now consistent with a 5.9 percent default rate, which is higher than the cur-

rent rate or the rates that rating agencies are forecasting, Fridson said.

In other words, spreads are compensating investors for even more default risks than are likely.

The current default rate, or the last three months' rates annualized, is just 5.4 percent, while Moody's Investors Service is forecasting the rate will be 3.4 percent a year from now, Fridson noted.

"Unless the economy worsens, we're unlikely to see anything as high as 5.9 percent," he said.

INSIDE DEBT is produced by Reuters in partnership with ICAP.

(Compiled by Anil Kumar and Pronita Naidu in Bangalore)

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