

INSIDE DEBT

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Friday, February 19, 2010

CHART OF THE DAY

Fed rate hike hits commodities as dollar rises



Prices of key commodities fell, stung by a surge in the dollar after a surprise hike in the U.S. Federal Reserve discount rate, leading investors to examine the basis of major investment in the asset class.

TODAY'S TOP NEWS

- Fed seeks to calm markets after discount rate rise
- U.S. inflation tame, supports Fed's low rate vow
- Obama announces new fund to address U.S. housing woes
- U.S. mortgages foreclosure rate at 15 pct in Q4
- Euro zone PMI point to slow and steady growth
- Futures push rate hike bets sooner on Fed move
- Greece mulling extra deficit cutting measures -PM
- Canadians spending way to recovery, data shows
- ECB's Gonzalez-Paramo: want money markets back on feet
- UK retail sales tumble in January snow

ECON WATCH

FOR MONDAY FEBRUARY 22

ET	Indicators	Unit	Reuters	Prior
04:00	IT Flash Trade non-EU	bln	-	1.262
08:30	US Chicago Fed Index	ind	-	-0.61

MARKETS TODAY

TODAY'S TOP STORY: The Federal Reserve poured more cold water on speculation that a surprise hike to its emergency lending rate signaled a change in monetary policy, saying borrowing costs in the economy would remain low. **For more please click here**

TREASURIES: U.S. Treasuries were little changed, stabilizing after the Federal Reserve's surprise hike in its emergency lending rate sent shorter-dated debt reeling less than 24 hours ago.

- 2-yr notes rose 1/32 to yield 0.92 pct. Earlier losses in the session pushed their yields as far as 0.97 pct, their highest since mid-January.
- 30-yr bond prices rose 11/32 to yield 4.71 pct, down from 4.73 pct.
- 10-yr Treasury prices rose 7/32 to yield 3.78 pct from 3.81 pct.
- 5-yr Treasury prices were up 3/32 to yield 2.46 pct.
- The difference in the yields of 10-yr notes and 10-yr TIPS narrowed to 2.27 pct from 2.3 pct just before the inflation data.

FOREX: The dollar climbed, touching an eight-month high against a currency basket, a day after the Federal Reserve raised the interest rate it charges banks for emergency loans.

- Dollar index was up 0.29 pct to 80.631, after rallying to an eight-month high of 81.342.
- The euro rose 0.52 pct at \$1.3599. Earlier, it fell as low as \$1.3444, its lowest level in nine months.
- Dollar fell 0.12 pct to 91.64 yen while euro rose 0.38 pct to 124.61 yen.
- Sterling shed 0.53 pct to \$1.5456.

CORPORATES: U.S. corporate bonds, led by high-yield debt, gained this week as some concerns about sovereign debt risk abated and as a benign inflation report lessened the impact of a surprise hike in the U.S. discount rate.

- The CDX.IG-13 index tightened by about 2 bps to 91 bps.
- Barclays Capital said credit market's next week will likely take their cue from housing data set for release next week, as well as quarterly earnings from companies such as Home Depot and Target.

STOCKS: U.S. stocks edged higher in choppy trading as investors took the Federal Reserve's surprise increase in its discount rate as further evidence the financial system is strengthening.

- Dow rose 0.09 pct to 10,402.12, S&P gained 0.21 pct to 1,109.09 and Nasdaq was up 0.10 pct to 2,243.87.
- Schlumberger Ltd shares fell 2.90 pct to \$63.9 while Smith International shot up 13.07 pct to \$37.71.
- FedEx Corp shares rose 2.07 pct to \$81.76.
- U.S. Steel Corp was up 4.57 pct to \$53.29 which boosted the S&P materials sector by 0.44 pct. KBW bank index jumped 1.26 pct.

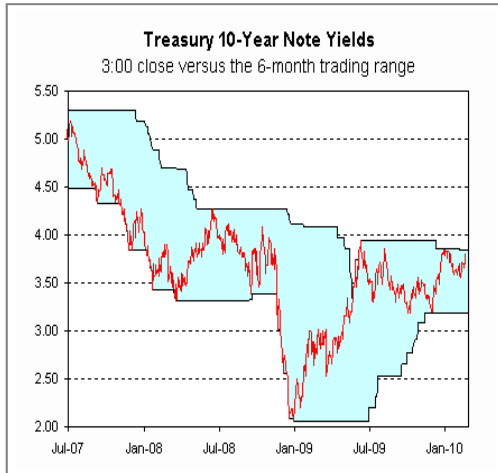
C & E: Oil prices rose as French refinery strikes and tensions about Iran's nuclear program outweighed fears that U.S. monetary tightening could slow demand growth in the world's largest oil consumer.

- U.S. crude prices was up 1.14 pct to \$79.96.
- Gold rose 0.50 pct to \$1,116.95 an ounce.
- Reuters-Jefferies index was up 0.6 pct at 277.8.

- 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	0.075	0.040	0.076	-0.006
3-Mo Bill	0.100	0.090	0.101	-0.007
6-Mo Bill	0.190	0.185	0.193	0.008
1-Year	0.360	0.350	0.366	-0.035
2-Year	99.898	99.930	0.929	0.008
3-Year	99.609	99.648	1.510	0.008
5-Year	99.000	99.047	2.466	0.055
7-Year	99.313	99.359	3.236	0.039
10-Year	98.672	98.734	3.786	0.172
30-Year	98.656	98.719	4.709	0.391

EQUITIES

	INDEX	CHANGE
DJIA	10401.14	8.24
NASDAQ	2243.22	1.51
S&P 500	1108.94	2.19

OIL

	PRICE	CHANGE
NYMEX	79.8	0.8
BRENT	77.5	-0.3

EURODOLLAR FUTURES

	CLOSE	CHANGE
Mar-10	99.713	-0.010
Jun-10	99.580	-0.015
Sep-10	99.335	-0.045
Dec-10	98.990	-0.055

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.200	O/N	0.210
2-Week	0.200	2-Week	0.210
1-Month	0.200	1-Month	0.220
3-Month	0.200	3-Month	0.240
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.200	10:00 AM	0.140
2-Week	0.200	3:00 PM	0.128
1-Month	0.210		
3-Month	0.210		

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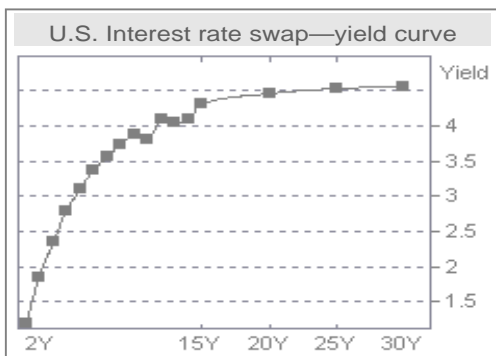
	SPREAD		RATE	
2-Year	27.50	31.50	1.19	1.22
3-Year	33.50	37.50	1.84	1.85
5-Year	32.25	36.25	2.78	2.78
7-Year	13.75	17.75	3.37	3.36
10-Year	8.75	12.75	3.87	3.86
30-Year	-14.50	-10.50	4.56	4.54

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.02	-0.13
CBOT 10 yr	117.14	-0.06
CBOT 30 yr	116.28	0.09

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.140	0.150	-	-
1-Month	0.180	0.280	0.128	0.138
3-Month	0.220	0.400	0.157	0.167
6-Month	0.250	0.450	0.195	0.205
12-Month	0.600	1.000	0.366	0.376



CURRENCIES

	BID	ASK
Euro	1.3598	1.3600
Sterling	1.5466	1.5470
JP Yen	91.68	91.70
Swiss Franc	1.0769	1.0772
Can Dollar	1.0403	1.0408
Mexico	12.8113	12.8176

FED FUNDS NYFRSM - 10AM

Open	0.1400	1m	0.2137
High	0.1700	3m	0.2531
Low	0.0800		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.875	12/01/2012	9	0	1.02
3-Year	1.375	09/01/2013	13.25	12.75	1.64
5-Year	2.875	09/02/2015	29.5	0	2.79
7-Year	5.125	18/10/2016	18.25	17.5	3.42
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	35.5	35	5.06

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	4	0	0.97
3-Year	1.75	22/02/2013	20	19.5	1.71
5-Year	2.625	20/11/2014	15.5	15	2.63
7-Year	5.25	15/09/2016	16	15.25	3.4
10-Year	3.75	27/03/2019	23.5	0	4.03
30-Year	6.25	15/07/2032	39	38.5	5.1

Active MBS 15YR

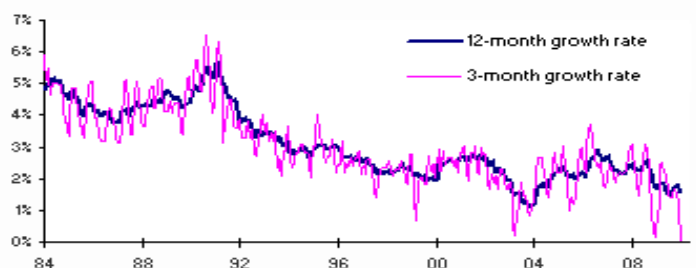
	CPN	BID	ASK	YIELD
FNMA	5.0	105.0000	105.0200	2.779
FHLMC	5.0	105.0100	105.0300	2.767

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.0200	105.0400	3.142
FHLMC	5.5	105.1100	105.1300	2.978
GNMA	5.5	105.1400	105.1600	3.613

Wrightson ICAPSM Chart of the Day

Annualized Growth in the Core CPI



TODAY'S TOP NEWS

Fed seeks to calm markets after discount rate rise

The Federal Reserve poured more cold water on speculation that a surprise hike to its emergency lending rate signaled a change in monetary policy, saying borrowing costs in the economy would remain low.

The president of the New York Fed, William Dudley, said the central bank's pledge to keep benchmark borrowing costs low for an extended period of time "is still very much in place."

The Fed raised its discount rate by a quarter percentage point to 0.75 percent late Thursday, after the close of U.S. financial markets. Three Fed officials had also stressed that the move did not represent a tightening of U.S. monetary policy.

Dudley, speaking at a conference in San Juan, Puerto Rico, described Thursday's decision to lift the discount rate as a small technical change that carried no broader signals about U.S. monetary policy.

Dudley said he would be "very comfortable" with the exit strategy sequence outlined by Fed Chairman Ben Bernanke in his Feb. 10 testimony.

Obama announces new fund to address U.S. housing woes

President Barack Obama used a campaign push for Senate Majority Leader Harry Reid to announce a new fund to support homeowners in five states hit hardest by the U.S. housing crisis. Obama said he is designating \$1.5 billion from the TARP to fund programs at local housing finance agencies in California, Florida, Nevada, Arizona, and Michigan, which have seen home prices decline more than 20 percent from their peaks.

"This fund's going to help out-of-work homeowners avoid preventable foreclosures," Obama told a town hall-style meeting at school near Las Vegas. Nevada is still struggling from the home market crash, and Obama's choice to make the announcement there was no accident.

The president is trying to boost Reid, a Nevada Democrat who trails potential Republican opponents by double digits in opinion polls ahead of November elections that could change the balance of power in Congress.

Reid has helped push Obama's agenda to boost the economy, overhaul the U.S. healthcare system and fight climate change, but Republican critics say he has neglected his home state while working on the national stage.

Euro zone PMIs point to slow and steady growth

The euro zone's manufacturing sector had its best month in 2-1/2 years in February helped by German strength but the dominant service sector expanded at a slower pace than expected, a survey showed. Markit's Flash PMI Composite index held steady at 53.7 this month, pipping expectations for 53.5.

Markit's services index fell to 52.0 in February from 52.5 in January. That marks the sixth month the services index was above the 50.0 mark that divides growth from contraction but was short of a Reuters poll consensus of 52.5.

The flash manufacturing index rose to 54.1 in February from 52.4 in January, smashing forecasts for a slight rise to 52.6, while the output index jumped to 56.9 this month, the highest since April 2007, from 56.0 in January.

Separately, business confidence in the French manufacturing sector stagnated in February as company chiefs expressed uncertainty over the future amid gloom over order books and production prospects. INSEE's monthly business morale indicator for February of 91 was unchanged from January's reading which was revised down from 92, its highest level since September 2008.

U.S. inflation tame, supports Fed's low rate vow

U.S. consumer prices edged higher in January, while prices excluding food and energy fell for the first time in 27 years, supporting the Federal Reserve's contention it would keep its benchmark interest rate low for an "extended period."

The Labor Department said the CPI rose 0.2 percent last month, lifted by a spike in energy costs, after increasing 0.2 percent in December. That was below market expectations for a 0.3 percent gain.

The core measure of inflation fell 0.1 percent, the first decline since December 1982. Analysts had expected a 0.1 percent rise. The costs of new vehicles, shelter and apparel fell, as did airline fares and recreation prices.

The decline reflected a 0.1 percent dip in the department's measure of homeownership costs, which accounts for a quarter of the overall CPI, and a 2.1 percent decline in the price of lodging away from home.

Compared to a year ago, the core inflation rate rose 1.6 percent after increasing 1.8 percent in December.

U.S. mortgages foreclosure rate at 15 pct in Q4-MBA

A record proportion of U.S. mortgages were in foreclosure or at least one payment past due in the fourth quarter, according to industry data showing the fragile state of the recovery in the housing market.

The MBA said the combination of loans in foreclosure and one payment in arrears was 15.02 percent on a non-seasonally adjusted basis, the highest ever in the survey.

However, the delinquency rate for mortgages on one-to-four-unit residential properties fell to a seasonally adjusted rate of 9.47 percent of all loans outstanding as of the end of the fourth quarter of 2009, down from 9.64 percent in the third quarter but up from 7.88 percent in the same quarter a year earlier.

30-day delinquencies fell to 3.63 percent from 3.79 percent.

The percentage of loans on which foreclosure actions were started fell to 1.20 percent in the fourth quarter, down from 1.42 percent in the third quarter but up from 1.08 percent in the same quarter a year earlier, the MBA said. The U.S. foreclosure inventory rate for all loans was 4.58 percent in the fourth quarter, up from 4.47 percent in the third quarter.

Separately, ECRI said its Weekly Leading Index fell to 128.4 for the week ended Feb. 12 from 130.0 the prior week.

It was the lowest reading since November 13, 2009, when it stood at 127.5.

Futures push rate hike bets sooner on Fed move

Investors ramped up bets on a rate hike later this year and pulled up yields on Treasury bills, after last night's move by the Fed to raise emergency borrowing costs for banks surprised markets.

The Fed took its discount rate to 0.75 percent from 0.5 percent, but said this was not a precursor to a tightening cycle.

"The discount rate move is part of a normalization process, which is akin to our discontinuing many of our liquidity programs," St. Louis Fed President James Bullard said yesterday.

"And it does not indicate anything one way or the other about what we might eventually do with the federal funds rate," he added.

This week, fed funds futures contracts had perfectly priced in a rate hike of 25 basis points by November.

Three-month dollar Libor rates were slightly higher at 0.25194 percent, while equivalent euro rates also edged up to 0.60625 percent.



TODAY'S TOP NEWS

Greece mulling extra deficit cutting measures -PM

Greece is considering imposing extra austerity measures suggested by the European Union to restore credibility with investors and escape its fiscal crisis, Prime Minister George Papandreou said.

"There needs to be an assessment to see what needs to be done before we take a decision (on additional measures)," he told Greek reporters during a visit to London.

He made clear Athens might need financial assistance from the EU as well as the political backing it has received.

Separately, Greece deserves the support of the European Union but must take the action necessary to fix its public finances crisis, European Union Competition Commissioner Joaquin Almunia said.

"Greece has very serious problems that can only be tackled from Greece," Almunia told a conference of left-wing policymakers in London.

Canadians spending way to recovery, data shows

Consumer spending and a sizzling housing market are powering Canada's economic recovery, two reports showed, suggesting a surge in growth at the end of last year will lead to a strong start to 2010.

Retail sales in December resumed their climb after a downturn in November, Statistics Canada said, although the 0.4 percent increase was slightly below expectations. Volumes, however, were up 0.6 percent. Scotia said it is possible that growth in the fourth quarter will exceed its forecast of 4.2 percent annualized, and that its assumption of 2.7 percent growth in real consumption may be too low.

Canada's composite leading indicator continued to climb in January, Statscan also reported on Friday, although the 0.9 percent gain was slower than in December. Strong household spending as well as housing starts and existing home sales lifted the index while manufacturing exerted a drag. The number of Canadians receiving employment insurance benefits fell for the third straight month in December, declining 5.1 percent, the agency said in another sign the recovery is taking root.

ECB's Gonzalez-Paramo: want money markets back on feet

Getting money markets back in working order is a priority for the European Central Bank and emergency liquidity will be unwound only gradually, Executive Board member Jose Manuel Gonzalez-Paramo said.

"We want the money market back on its feet," Gonzalez-Paramo told reporters on the sidelines of a conference organized by the Institute of International and European Affairs.

"We have phased out a number of measures. The fact that market rates didn't move proves that we were right. We (intend) to remain right in deciding progressively to phase out the measures."

The ECB started in December to gradually withdraw support to banks it had started due to the financial crisis.

Gonzalez-Paramo also said euro-zone countries have to be credible and committing to budget measures is very important for governments to regain credibility.

UK retail sales tumble in January snow

British retail sales fell at their sharpest pace in 1-1/2 years in January as the harshest cold snap in 30 years and a rise in value-added tax kept people away from the shops.

The Office for National Statistics said sales volumes fell 1.8 percent last month.

That was more than three times the drop forecasts by analysts and the biggest monthly slide since June 2008.

On the year, sales were up 0.9 percent, the weakest annual growth in seven months.

Analysts were reluctant to read too much into the figures given the distortions from the weather, calculation changes and a 2.5 percentage point rise in VAT to 17.5 percent on Jan. 1. But they agreed there was a growing risk Britain's economy could shrink at the start of this year.

The statistics office said unusually heavy snowfall last month had pushed down sales of household goods, food and fuel.

Retail prices rose an annual 2.3 percent in January, the fastest rise since September 2008, when consumer price inflation was running at a record high 5.2 percent.

NEXT UP

POLL-Dealers' Fed outlook same after discount rate hike

The large financial firms that do business directly with the Federal Reserve do not believe the Fed's move on Thursday to raise the discount rate reflects a broader shift in its monetary policy, according to a Reuters poll.

Though the market for federal funds rate futures rose and the yield on the two-year Treasury note reached a month-long high following the Fed's announcement on Thursday, primary dealers agreed that the decision to increase the rate on loans from the discount window was not the start of monetary tightening.

The Fed also purchased assets during the crisis to support the market for mortgage-backed securities, and minutes from the January FOMC meeting showed a broad spectrum of opinions on how best to handle the assets the Fed purchased, including when to sell them.

Only one of the 12 dealers offering forecasts on asset sales thought the Fed would begin selling assets in 2010; five said it would wait until 2011, while three thought the sales would begin in 2012.

Overall, dealers said the Fed's intentions seemed reasonably clear, and that its discount rate hike was widely anticipated.

Morale up for German business, but not consumers

German business sentiment rose more than expected in January to its highest level in 1-1/2 years. Another rise would boost hopes the recovery will gather pace once Europe's largest economy emerges from a harsh winter.

Ifo to rise to 96.1 from 95.8; GfK to fall to 3.0 from 3.2; jobless rate to remain steady at 8.2 percent; CPI to rise 0.5 percent month-on-month.

Hopes have been pinned mostly to an export-driven recovery in the economy. Exports rose by 3.0 percent on the month in December, pushing foreign demand above the year-ago level for the first time in 14 months.

However, data points towards a stuttering recovery and many economists see unemployment rising in the coming months, impacting private consumption.

The jobless total rose by 6,000 on the month in January to a seasonally adjusted 3.429 million. Meanwhile, the GfK consumer sentiment indicator, based on a survey of about 2,000 Germans, fell to 3.2 for February from a revised 3.4 in January.

A stronger-than-expected rise of the Ifo index could drive the euro higher against the dollar and push down Bund futures.



DEEP DIVE Commentary and Analysis

Rate hike furor shows delicate task ahead for Fed

By Ann Saphir

The sharp financial market reaction to the Federal Reserve's discount rate increase -- despite its assurances that the hike is not monetary tightening -- shows the tricky communication task officials face as they tiptoe toward an eventual change in rate policy.

The Fed's announcement on Thursday that it was increasing the rate it charges banks for emergency loans to 0.75 percent from 0.50 percent knocked down global stocks and commodity prices and pushed up the U.S. dollar.

It prompted futures traders to boost bets the Fed will raise its benchmark short-term interest-rate target by September, even though the Fed signaled it is still committed to holding that rate ultra low for "an extended period."

"To some extent, the market's reaction must be quite perturbing to the Fed," said Alan Ruskin, head of currencies for RBS Global Banking and Markets in Greenwich, Connecticut.

"The concern from the Fed must be, 'Now what happens when we really want to do something substantive?'"

It was the first increase in lending rates by the U.S. central bank since it lowered its target for overnight interbank borrowing rates, its main policy lever, to near zero in December 2008 to battle a deep recession and severe financial crisis.

Fed Chairman Ben Bernanke said just last week the central bank would soon consider raising the discount rate, but the timing of the move still caught markets off guard. Usually, the discount rate would move in lock-step with the interbank federal funds rate.

Bernanke also took pains to explain a discount rate hike would signal only a return to more normal conditions, not a change in monetary policy. But markets did not fully heed the message.

"We always have a communication challenge," New York Federal Reserve Bank President William Dudley told reporters on Friday.

"There are people sitting at their desk looking at the screens all day long who are extremely knowledgeable and know exactly what's going on and there are those that just casually see the headline in the newspaper and don't have a way of evaluating what that discount rate increase means."

CONCERTED COMMUNICATIONS EFFORT

Dudley, along with St. Louis Fed President James Bullard, Atlanta Fed chief Dennis Lockhart and Fed Governor Elizabeth Duke, were quick to reiterate the central bank's position that raising the discount rate is not the same as broadly boosting borrowing costs.

"I would not interpret this action as a tightening of monetary policy or even a sign that a tightening is imminent," Lockhart said on Thursday.

The fragility of the economic recovery, and the need for continued low rates to support it, is a topic that Bernanke is likely to address next week in semiannual testimony to Congress.

With the U.S. unemployment rate at a lofty 9.7 percent and ample spare capacity at factories, Fed officials do not see an imminent inflation risk that would warrant higher borrowing costs for businesses and consumers.

A government report on Friday showed consumer prices excluding volatile food and energy costs fell in January for the first time since 1982, bolstering the Fed's low-rate case.

But even after the calming inflation news, federal funds futures contracts still suggest traders see a higher likelihood of an interest-rate increase by September than they did before the Fed's announcement.

The markets' reaction "shows the limitations in just how much

you can smooth out the kinks in the way the market receives information," Ruskin said.

Michael Pond, a bond market strategist at Barclay's Capital in New York, said the Fed may have been trying to "test the markets."

"There are occasions when the Fed wants to surprise the markets," he said. "They learned a lesson back in 2004 to 2006, that providing too much certainty led to the market taking on too much risk."

Ruskin said, however, that Thursday's sharp market reaction showed how careful the Fed would need to proceed when it eventually feels the time is right to begin tightening monetary policy.

"The reaction from yesterday is testament that they will have to be quite deft in their flagging of tightening, when they actually do tightening," he said. "As they then progress," he added, "it becomes less imperative that they flag every move."

Sovereign CDS moves may overplay default fears

By Karen Brettell

Recent spikes in credit default swaps on sovereign debt have added to concerns that some countries may struggle to repay debt, however not all CDS moves should be viewed as a play on their default probability.

CDS, which were blamed for adding to fears about financial firms including Lehman Brothers before it failed in 2008, have come back into focus as debt protection costs on sovereign nations surge, led by peripheral European nations including Greece and Portugal.

Critics of the market blame speculators for using the contracts to bet against a country, which they say could in turn push its borrowing costs higher and hurt its access to capital markets, possibly sending it into a negative spiral.

While rising costs in some cases reflect fears over a country's ability to repay surging debt loads, some attention paid to CDS moves may overstate what the contracts imply about a country's risk of default.

This is because much of the trading in the contracts is done by investors placing macro hedges against currency, financial or other systemic risks, rather than trading based on any potential of a default, and an imbalance of protection buyers relative to sellers can make these moves more dramatic.

MORE RELATIVE VALUE PLAYS

"There is a limited universe of investors in a position to sell sovereign CDS protection," said Ashish Shah, co-head of credit strategy at Barclays Capital in New York.

Trading is also increasingly influenced by relative value strategies, as it becomes more clear that the risk of countries that had previously traded in close ranges are widely divergent.

"Much of the CDS trading today is based on relative value. Two years ago Germany and Greece traded within a few basis points of each other and it's obvious that should not be the case," said Brian Yelvington, analyst at Knight Libertas in Greenwich, Connecticut.

Greece's five-year CDS costs surged to an end-of-day peak of 425 basis points earlier this month, up from 282 basis points at the beginning of the year and around 20 at the beginning of 2008. The spread has since pulled back to around 355 basis points.

Germany's debt protection costs, by comparison, are trading at around 44 basis points, down from a peak of around 91 basis points in early 2009. Its swaps had traded around 6 basis points in early 2008.

Trading of CDS on stronger countries, including Germany, the



DEEP DIVE Commentary and Analysis

United Kingdom and the United States, is especially dominated by macro hedging and relative value strategies, as a default by one of these nations is deemed very unlikely, and if it were to occur, catastrophic.

TRADING IMBALANCES

An imbalance of protection buyers relative to sellers, can make CDS moves more volatile and muddy readings into what the contracts say about the probability of default.

CDS on a country and its financial institutions are highly correlated, as a country's default is likely to also cause widespread harm to its banks. For many countries, such as the United States, this can limit the number of banks able to trade the contracts.

"U.S. entities can't sell protection on USA CDS, so the natural investor base that is long protection is relatively small compared

to the number of investors that can invest in Treasury bonds," said Barclays' Shah.

Selling protection on the United States is further complicated by the contracts being denominated in euros, which is designed to protect buyers against additional currency losses on the dollar that may occur if an event badly damages the value of U.S. debt.

"There is currency risk because the contracts are denominated in euros," said Shah.

Meanwhile, sovereign CDS also have not had the same flow of protection sellers through structured credit vehicles as corporate CDS markets, which traditionally have been key to balancing demands to buy protection.

Analysts, however, expect trading in structured vehicles, including those based on indexes, to pick up for sovereign risk following recent launches of sovereign CDS indexes.

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