

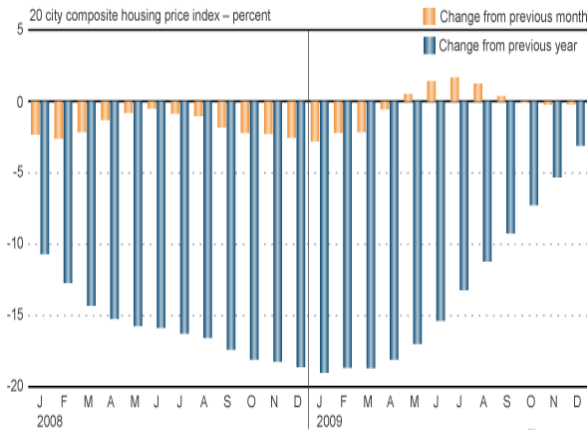
INSIDE DEBT

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Tuesday, February 23, 2010

CHART OF THE DAY

U.S. home prices



U.S. home prices unexpectedly slipped in December but the annual rate of decline slowed, reinforcing the housing market's rocky road to recovery, S&P's/Case-Shiller indexes showed.

TODAY'S TOP NEWS

- U.S. confidence sags on jobs worry, Washington gridlock
- U.S. FDIC reports 27 pct jump in problem banks
- U.S. Treasury resumes Supplementary Financing Program
- Too soon to pull stimulus in 2010, IMF says
- Strong demand snaps up \$44 bln in 2-yr U.S. Treasuries
- Business, consumer gloom weighs on euro zone recovery
- C.Bank head says Greece must reform or pay price
- Fed Home Loan Bank lending drops by one-third in 09

ECON WATCH

FOR WEDNESDAY FEBRUARY 24

| ET | Indicators | Unit | Reuters | Prior |
|-------|---------------------------|--------|---------|--------|
| 02:00 | DE GfK consumer sentiment | ind | 3.0 | 3.2 |
| 05:00 | EZ Industrial new orders | mm % | -1.0 | 2.7 |
| 05:00 | EZ Industrial new orders | yy % | 6.0 | -0.5 |
| 07:00 | US Mortgage market index | ind | - | 600.5 |
| 07:00 | US Mortgage refi. index | ind | - | 2860.1 |
| 10:00 | US New home sales | mm mln | 0.36 | 0.342 |

SPECIAL REPORT:

How long can the U.S. dollar defy gravity?

The only time the U.S. dollar ever took a serious shel-lacking in the marketplace, the wounds were almost entirely self-inflicted. **For more please click here**

MARKETS TODAY

TODAY'S TOP STORY: U.S. consumer confidence sagged to a 10-month low this month on worries about jobs and fears gridlock in Washington could hinder efforts to restart employment, curbing the economic recovery. **For more please click here**

TREASURIES: U.S. Treasury debt prices shot higher as a plunge in U.S. consumer confidence in February sent traders scrambling to buy lower-risk government debt.

- The 2-yr sale attracted bids worth 3.33 times the amount on offer, above the average of 3.12 times over the last six months.
- 30-yr bond yields rose 1-19/32 to yield 4.63 pct, down from 4.73 pct on Monday.
- 10-yr Treasury prices rose 29/32 to yield 3.69 pct, on track for the biggest single-day dip in yields in six weeks.
- 5-yr Treasury prices were up 15/32 to yield 2.35 pct.
- 2-10's part of the yield curve tightened by 6 bps to 285 bps.

FOREX: The dollar fell against the yen but rose against the euro after U.S. consumer confidence slid to a 10-month low and sapped risk appetite.

- Dollar was down 1.05 pct to 90.19 yen while the euro fell 1.69 pct to 121.83 yen.
- The euro fell 0.64 pct to \$1.3506, after dropping as low as \$1.3497.
- Sterling shed 0.42 pct to \$1.5416.
- Dollar index gained 0.52 pct to 80.927.

CORPORATES: U.S. corporate bond spreads widened as stocks fell and U.S. Treasury debt prices gained after disappointing economic data raised further doubts about the strength of the recovery.

- The CDX.IG-13 index widened by about 3 bps to 94 bps.
- JPMorgan Chase launched \$1.1 bln of three-year floating-rate notes.
- Diversified U.S. manufacturer United Technologies Corp sold a \$2.25 bln two-part debt sale.

STOCKS: A worse-than-expected drop in consumer confidence pushed U.S. stocks lower as investors worried over what remains one of the weakest areas of the economy.

- Dow fell 0.97 pct to 10,282.41, S&P was down 1.21 pct to 1,094.61 and Nasdaq shed 1.28 pct to 2,213.44.
- Home Depot Inc shares rose 1.42 pct to \$30.75.
- Intel Corp dropped 2.35 pct at \$20.38, while the PHLX semiconductor index lost 2.83 pct.
- S&P financial index fell 1.77 pct, S&P energy index was down 1.5 pct, S&P technology shed 1.37 pct. KBW bank index fell 2.33 pct.

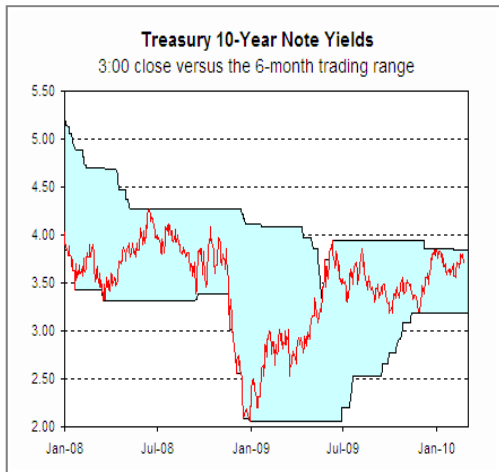
C & E: Oil prices dropped more than \$1, breaking a five-day rally, as a fall in U.S. consumer confidence and German business sentiment sent investors into safer havens, such as the dollar.

- U.S. crude prices fell 1.99 pct to \$78.71 per barrel. Earlier, it fell as low as \$78.22.
- Gold fell 1.05 pct to \$1,101.9 an ounce.
- Reuters-Jefferies index shed 1.66 pct at 272.18.

- 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 | 0.080 | 0.045 | 0.081 | 0.015 |
| 3-Mo Bill | 0.115 | 0.105 | 0.117 | 0.026 |
| 6-Mo Bill | 0.195 | 0.185 | 0.198 | 0.009 |
| 1-Year | 0.333 | 0.330 | 0.338 | -0.003 |
| 2-Year | 100.055 | 100.086 | 0.847 | 0.086 |
| 3-Year | 99.859 | 99.898 | 1.424 | 0.176 |
| 5-Year | 99.500 | 99.547 | 2.358 | 0.418 |
| 7-Year | 100.016 | 100.063 | 3.122 | 0.703 |
| 10-Year | 99.422 | 99.484 | 3.695 | 0.875 |
| 30-Year | 99.859 | 99.922 | 4.634 | 1.555 |

EQUITIES

| | INDEX | CHANGE |
|---------|----------|--------|
| DJIA | 10299.80 | -83.58 |
| NASDAQ | 2217.22 | -24.81 |
| S&P 500 | 1096.77 | -11.24 |

OIL

| | PRICE | CHANGE |
|-------|-------|--------|
| NYMEX | 78.9 | -1.4 |
| BRENT | 77.6 | -1.0 |

EURODOLLAR FUTURES

| | CLOSE | CHANGE |
|--------|--------|--------|
| Mar-10 | 99.725 | 0.005 |
| Jun-10 | 99.620 | 0.025 |
| Sep-10 | 99.425 | 0.045 |
| Dec-10 | 99.115 | 0.065 |

REPURCHASE AGREEMENTS

| G/C | | MORTGAGE REPOS | |
|--------------|-------|----------------------------|-------|
| O/N | 0.170 | O/N | 0.170 |
| 2-Week | 0.210 | 2-Week | 0.210 |
| 1-Month | 0.190 | 1-Month | 0.210 |
| 3-Month | 0.210 | 3-Month | 0.240 |
| AGENCY REPOS | | i-REPO SM INDEX | |
| O/N | 0.160 | 10:00 AM | 0.100 |
| 2-Week | 0.180 | 3:00 PM | 0.093 |
| 1-Month | 0.180 | | |
| 3-Month | 0.200 | | |

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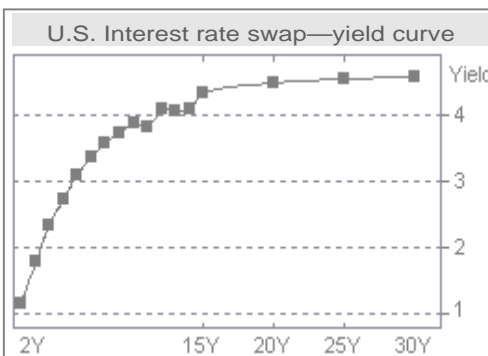
| | SPREAD | | RATE | |
|---------|--------|--------|------|------|
| 2-Year | 26.25 | 30.25 | 1.10 | 1.13 |
| 3-Year | 30.75 | 34.75 | 1.72 | 1.74 |
| 5-Year | 31.50 | 35.50 | 2.67 | 2.67 |
| 7-Year | 14.00 | 18.00 | 3.26 | 3.25 |
| 10-Year | 7.50 | 11.50 | 3.77 | 3.75 |
| 30-Year | -15.75 | -11.75 | 4.47 | 4.45 |

FUTURES

| | PRICE | CHANGE |
|------------|--------|--------|
| CBOT 5 yr | 116.18 | 0.47 |
| CBOT 10 yr | 117.39 | 0.20 |
| CBOT 30 yr | 116.63 | 0.25 |

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

| | BID | ASK | BID | ASK |
|----------|-------|-------|-------|-------|
| O/N | 0.130 | 0.150 | - | - |
| 1-Month | 0.200 | 0.280 | 0.133 | 0.143 |
| 3-Month | 0.220 | 0.400 | 0.159 | 0.169 |
| 6-Month | 0.250 | 0.450 | 0.188 | 0.198 |
| 12-Month | 0.600 | 1.000 | 0.330 | 0.340 |



CURRENCIES

| | BID | ASK |
|-------------|---------|---------|
| Euro | 1.3522 | 1.3524 |
| Sterling | 1.5436 | 1.5442 |
| JP Yen | 90.18 | 90.20 |
| Swiss Franc | 1.0827 | 1.0830 |
| Can Dollar | 1.0552 | 1.0556 |
| Mexico | 12.9026 | 12.9082 |

FED FUNDS NYFRSM - 10AM

| | | | |
|------|--------|----|--------|
| Open | 0.1400 | 1m | 0.2175 |
| High | 0.1500 | 3m | 0.2569 |
| Low | 0.0800 | | |

ACTIVE FANNIE MAE AGENCIES

| TERM | COUPN | MATURITY | YIELD-SPREAD | YIELD |
|---------|-------|------------|--------------|-------|
| 2-Year | 0.875 | 12/01/2012 | 6.5 0 | 0.91 |
| 3-Year | 1.375 | 09/01/2013 | 14 0 | 1.59 |
| 5-Year | 2.875 | 09/02/2015 | 29 28 | 2.66 |
| 7-Year | 5.125 | 18/10/2016 | 18.75 18.25 | 3.31 |
| 10-Year | - | - | - - | - |
| 30-Year | 6.625 | 15/11/2030 | 35.5 31 | 5.03 |

ACTIVE FREDDIE MAC AGENCIES

| TERM | COUPN | MATURITY | YIELD-SPREAD | YIELD |
|---------|-------|------------|--------------|-------|
| 2-Year | 1.125 | 15/12/2011 | 3 0 | 0.91 |
| 3-Year | 1.75 | 22/02/2013 | 19 18 | 1.61 |
| 5-Year | 2.625 | 20/11/2014 | 16 15 | 2.53 |
| 7-Year | 5.25 | 15/09/2016 | 16.25 15.5 | 3.28 |
| 10-Year | 3.75 | 27/03/2019 | 18 16.5 | 3.9 |
| 30-Year | 6.25 | 15/07/2032 | 28.5 28 | 4.92 |

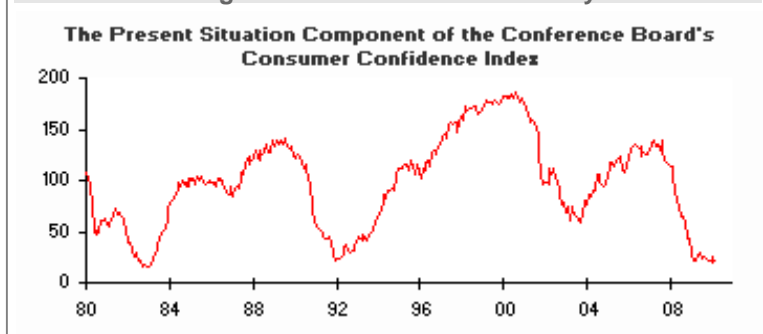
Active MBS 15YR

| | CPN | BID | ASK | YIELD |
|-------|-----|----------|----------|-------|
| FNMA | 5.0 | 105.0610 | 105.0810 | 2.702 |
| FHLMC | 5.0 | 105.0610 | 105.0810 | 2.702 |

Active MBS 30YR

| | CPN | BID | ASK | YIELD |
|-------|-----|----------|----------|-------|
| FNMA | 5.5 | 105.1110 | 105.1310 | 3.022 |
| FHLMC | 5.5 | 105.2310 | 105.2510 | 2.817 |
| GNMA | 5.5 | 105.2330 | 105.2530 | 3.521 |

Wrightson ICAPSM Chart of the Day



TODAY'S TOP NEWS

U.S. confidence sags on jobs worry, Washington gridlock

U.S. consumer confidence sagged to a 10-month low this month on worries about jobs and fears gridlock in Washington could hinder efforts to restart employment, curbing the economic recovery.

The housing market also remains rickety, data showed, further underscoring the economy's fragility.

The Conference Board said its index of consumer attitudes fell to 46.0 in February, the lowest since April last year and down from a revised 56.5 in January. The reading was also striking for how much it undershot the 55.0 median forecast from analysts polled by Reuters.

Adding to worries about the economy, the latest reading of Standard & Poor's/Case-Shiller indexes showed U.S. home prices unexpectedly slipped in December, but the annual rate of decline slowed, reinforcing that the housing market is on an uneven path to recovery.

The S&P composite index of home prices in 20 metropolitan areas declined 0.2 percent in December, matching the dip in November, for a 3.1 percent annual drop.

U.S. Treasury resumes Supplementary Financing Program

The U.S. Treasury Department said it will resume a program that had helped the Fed manage the size of its balance sheet.

The Treasury said that beginning Feb. 24 it will hold Supplementary Financing Program auctions over the next two months in the form of eight \$25 billion, 56-day bills.

The auction will be held every Wednesday over the next eight weeks with the intent of restoring the SFP back to the level maintained between February and September 2009, the department said. It said among slight differences from the previous program are the size of the auction and the length which will provide a little more flexibility. Also they will be offered over on a weekly rollover for eight straight weeks whereas they had offered either \$30 billion or \$35 billion for six consecutive weeks before halting for four weeks, the official said.

Separately, the Obama administration lowered expectations for the "Volcker rule" to curb risky trading by banks, emphasizing "limits" rather than an outright ban, as Congress shied from the original proposal.

Separately, the Senate Agriculture Committee will unveil a draft bill to increase oversight of over-the-counter derivatives in the next couple of weeks, said its chairman Blanche Lincoln. She said her committee is working closely with the Senate Banking committee, which is working on a broad package of financial regulatory reforms in the wake of the global economic crisis.

Strong demand snaps up \$44 bln in 2-yr U.S. Treasuries

The U.S. government sold \$44 billion worth of two-year debt in a well-bid auction that might signal strong demand for the rest of this week's record slate of bond offerings.

The two-year sale, the second of this week's four bond offerings totaling a record \$126 billion, attracted bids worth 3.33 times the amount on offer, above the average of 3.12 times over the last six months. Foreign central bank and large institutional investor demand was brisk, based on the indirect bidder category, which accounted for 53 percent of the sale.

This was above the average of 45.39 percent in the auctions since June, which has become a benchmark for comparisons due to changes in calculations that have boosted this category.

The recently growing direct bid accounted for about 8.0 percent of the sale, below its 10.5 percent average since June, but this didn't appear to affect reviews of the auction adversely.

U.S. FDIC reports 27 pct jump in problem banks

The number of "problem" U.S. banks jumped 27 percent during the fourth quarter of 2009 to 702, the highest level since 1993 and a sign that the industry's recovery remains uneven, regulators reported.

The FDIC said the industry overall eked out a profit of \$914 million for the quarter, benefiting from a healing economy, but said the improvement was concentrated in the largest banks.

FDIC Chairman Sheila Bair said the profit was a huge improvement over the \$37.8 billion loss the industry reported for the fourth quarter of 2008. "It's not that this was a strong quarter. It's simply that everything was so bad a year ago," Bair said in a statement. She later told reporters that although the number of problem banks "sounds scary," the bank industry is "challenged but stable." The additional provisions for expected bank failures sunk the balance of the FDIC's insurance fund even further to a negative \$20.9 billion at the end of the year.

Separately, the massive stimulus package passed last year to blunt the impact of the worst U.S. recession in 70 years created up to 2.1 million jobs in the last three months of 2009, the non-partisan CBO said.

Too soon to pull stimulus in 2010, IMF says

Economic conditions are too weak in most countries to justify removing emergency supports this year, the IMF said.

"Notwithstanding the recent pick-up in growth momentum, there is little evidence as yet that private demand is self sustaining," the IMF said in a research paper.

Once private demand shows sufficient strength, priority should be given to removing fiscal measures, such as temporary tax breaks and stimulus spending, over raising interest rates.

The Fund warned that government deficit and debt levels had risen to worrisome levels, and it will take a long-term combination of tax increases, spending cuts and reforms to entitlement programs such as pensions and healthcare to get public finances back on firm footing.

Separately, Former Federal Reserve Chairman Alan Greenspan said the U.S. economic recovery was "extremely unbalanced," driven largely by high earners benefiting from recovering stock markets and large corporations.

Greenspan did see signs pointing toward a modest recovery in job creation, saying that staffing levels at U.S. firms, which were deeply cut, remain below what is sustainable in the long run.

Business, consumer gloom weighs on euro zone recovery

Freezing weather hurt morale at German companies and job cuts worried Italian and French consumers in the first weeks of 2010, suggesting the euro zone's economy may all but grind to a halt in the first quarter.

Labor strikes around Europe added to a gloomy picture for a region already suffering from the fallout of a fiscal crisis in Greece. Germany's Ifo business sentiment data for February was worse than expected, hinting the continent's largest economy could contract in the first three months of 2010.

In France, households cut spending at the fastest pace in two years and in Italy consumer confidence dropped to its lowest level since last July.

The euro zone as a whole eked out 0.1 percent growth in the fourth quarter of last year, hurt by stagnation in Germany but helped by better-than-expected 0.6 percent growth in France.

Soaring unemployment has hurt consumer sentiment and fears over job cuts and budget cuts to get shaky public finances back on track contributed to a wave of strikes around Europe.



TODAY'S TOP NEWS

C.Bank head says Greece must reform or pay price

Greece's balance of payments deficit is unsustainable and the country will pay a huge price if it fails to press ahead with economic reforms, central bank governor George Provopoulos said. Greece is under mounting pressure from markets and EU policymakers to slash its large debt and deficit.

The central banker, also a member of the ECB's Governing Council, said the large debt and deficit were only partly due to the recession and mainly a result of chronic macroeconomic imbalances.

Meanwhile, the EU may have to help Greece, but any financial aid is likely to be more limited than the 20 to 25 billion euro plan reported by a German weekly, European Central Bank executive board member Lorenzo Bini Smaghi said on Monday.

Separately, Fitch Ratings downgraded the ratings of Greece's four largest banks, saying fiscal tightening by the government will weigh on the economy, affecting loan demand and hurting profits.

Fed Home Loan Bank lending drops by one-third in 09

Loans to U.S. banks from the FHLB system dropped by one-third in 2009 as financial institutions found cheaper credit sources, while they also reduced their lending, the FHLB's central finance office said.

Secured loans made by the 12 FHLBs to shareholder members declined 32 percent to \$631 billion at the end of December from a year earlier, the finance office said. Total assets of the FHLBs fell 25 percent to \$1.016 trillion.

The drop in loans, or "advances," came as member banks saw higher deposits and reduced demand for their loans due to the recession, the finance office said. Federal government programs that offered cheaper sources of funding also affected demand for advances, it said. Combined, net income for the FHLBs was \$552 million in the fourth quarter versus a \$715 million loss in the year-ago period, the finance office said.

Separately, U.S. commercial real estate is unlikely to show meaningful recovery before next year, a Realtors group said, citing high vacancy rates.

More asset-buying possible if UK outlook worsens -BoE

The Bank of England may still have to restart its asset-buying program if the economic outlook worsens, and things are not looking good in the euro zone, Governor Mervyn King said.

He also said that while ratings agencies were bound to be "somewhat uncertain" about the UK's fiscal outlook, Britain was in no danger of losing its precious triple-A credit status or about to face a Greek-style debt crisis.

While the central bank left the door open to more asset purchases when it halted the 200 billion program earlier this month, many analysts had been sceptical about whether the bank would do any more.

But economic data since the BoE's decision to halt its 11-month-old program has been mostly dire, with unemployment rising again and retail sales falling sharply, calling into question just how durable any recovery will be.

JGBs up; curve flatter on 20-yr auction prospects

Japanese government bonds edged higher as Tokyo equities slipped, with the yield curve flattening on expectations for good demand at a 20-year debt auction.

The 5-year/20-year yield spread narrowed to 164 basis points, the tightest in 11 days, after touching a decade high of 167 basis points last week, according to Reuters data.

Market players expect the 20-year JGBs to draw firm demand from investors like life insurers and pension funds, which are regular buyers of the maturities, as the new paper appears attractive. The coupon was set at 2.2 percent, the highest since the June 2009 tender, after the yield of the maturity rose to a three-month high of 2.175 percent on Monday.

But market watchers said they were unsure whether a firm auction outcome would have a lasting impact.

March 10-year JGB futures climbed 0.09 point to 139.39, edging back towards a seven-week high of 139.76 struck the previous week. The 10-year yield has moved between 1.300 and 1.380 percent so far this year.

The 20-year yield fell 1 basis point to 2.160 percent and the 30-year yield declined 1.5 basis points to 2.330 percent.

NEXT UP

Bernanke may smooth way for 5-year sale

Federal Reserve Chairman Ben Bernanke's made-for-TV testimony to Congress may be just the event to assuage bond traders' worries over this week's record volume of Treasury auctions. Coming during the halfway point of the four auctions worth a total of \$126 billion, analysts expect Bernanke to keep close to the Fed's script of low rates for an extended period.

This mantra has helped Treasuries recover from the shock of last week's surprise discount rate hike and weak data since then has reinforced the feeling that the Fed remains deeply worried about the headwinds facing the economy.

The result could be supportive for Treasuries if Bernanke does indeed tell markets he has no intention of dismantling the Fed's extraordinary monetary stimulus measures any time soon.

Though some bond investors have worried that too much easy money will eventually spur inflation and hurt long-dated Treasuries, a dovish tone from Bernanke on Wednesday might well underpin support for the five-year auction at 1 p.m. (1800 GMT). New home sales comprise the day's main data. They are also due at 10 a.m. and are expected to show a rise in January, which might dim the safe-haven allure of government bonds.

Hedge funds to invest more in troubled cos-survey

Hedge funds will increase their investments in distressed debt and equity this year and expect to make more money doing it, the Reuters HedgeWorld & Dykema 2010 Insolvency Outlook Survey found.

The most attractive areas for distressed investing in the next 12 months will be banking, energy and healthcare, according to the survey by the daily news service HedgeWorld and the law firm Dykema.

Of the 120 hedge fund managers who answered the questionnaire in December and January, 65 percent said at least some of their portfolios were invested in financially troubled companies, up from 53 percent in a year-earlier poll.

More than one in every three managers said they had put at least 20 percent of their portfolios into distressed debt, up from one in 10 a year earlier. A majority of those questioned said the risk profiles of distressed companies will be flat or on the decline this year, meaning hedge funds are likely to increase their profits by staying out of bankruptcy court.

In addition, hedge fund managers are buying more unsecured debt, which may be for sale at a sharp discount.



DEEP DIVE Commentary and Analysis

SPECIAL REPORT:**How long can the U.S. dollar defy gravity?**

By Steven C. Johnson, Kristina Cooke and David Lawder

The only time the U.S. dollar ever took a serious shellacking in the marketplace, the wounds were almost entirely self-inflicted.

Facing mounting inflation and the escalating cost of the Vietnam War, President Richard Nixon, on Aug. 15, 1971, took the United States off the gold standard, which had been in place since 1944 and required that the Federal Reserve back all dollars in circulation with gold.

The move amounted to a made-in-America double-digit devaluation, shocking the country's foreign creditors.

Deep inside the New York Federal Reserve Bank's fortress in lower Manhattan, Scott Pardee, then 34, was fielding frantic calls from central bankers around the world. They were demanding the United States cover the foreign exchange risk on their reserves.

"The whole roof came in on us," recalled Pardee, a former New York Fed staffer who is now an economics professor at Vermont's Middlebury College. "That is the kind of situation the U.S. doesn't want to be in."

Nearly 40 years later, the dollar still dominates world trade. At the height of the financial crisis in 2008, investors fled to the dollar as a temporary safe haven. But the dollar has been falling steadily since 2002, and as the world economy recovered last year, dollar selling resumed, reviving doubts about how long it could remain the world's unrivaled reserve currency.

The Greek debt crisis, which has sent investors stampeding back into the U.S. currency, has provided a reprieve. The dollar has gained some 10 percent against the euro since December. And following the Fed's decision last week to hike the discount rate it charges banks for emergency loans, the dollar rose even higher as some investors bet it would benefit from the eventual end to the Fed's post-crisis regime of easy money.

But a number of economists, investors and officials here and abroad interviewed for this story say the longer-term prognosis is far from rosy.

As the United States racks up staggering deficits and the center of economic activity shifts to fast-growing countries such as China and Brazil, these sources fear the United States faces the risk of another devaluation of the dollar. This time in slow motion -- but perhaps not as slow as some might think.

If the world loses confidence in U.S. policies, "there'd be hell to pay for the dollar," Pardee said. "Sooner or later, the U.S. is going to have to pay attention to the dollar."

French President Nicolas Sarkozy isn't on anybody's short list for the Nobel Prize in economics. But at January's World Economic Forum in Davos Sarkozy proposed, to scattered applause, creating a new version of the Bretton Woods currency accord, which set up the very gold standard that Nixon brought crashing down.

Most economists doubt a return to the gold standard is feasible in today's interconnected world, with so much capital crossing borders at the click of a mouse.

Yet, as Gian Maria Milesi-Ferretti, a foreign exchange expert at the International Monetary Fund in Washington, put it: "Post-crisis, a lot more things are on the table. It is true among policymakers and in the markets that people are much more willing to look at unconventional proposals and even some proposals that may seem antiquated."

ACROPOLIS NOW

Some argue the dollar's recent rally against the euro and yen (it's up almost 6 percent against the Japanese currency since December) is less a vote of confidence than a realization that

it's simply the best of a bad bunch.

Per Rasmussen, a retired currency trader who worked at Chase in the late 1970s in London, called it a "reverse beauty pageant" in which investors pick the "least ugly" contestant.

Since rising above \$1.50 in November, the euro has tumbled more than 10 percent and was last changing hands around \$1.3550, near a nine-month low.

The currency has been battered by doubts about whether Greece and other wobbly euro zone economies can manage the spending cuts needed to rein in out-sized budget deficits. The worries have weakened confidence in the whole concept of European monetary union.

Thomas Kressin, who helps manage PIMCO's \$100 million GIS FX strategy fund, said the euro is in danger of entering into an extended downtrend that takes it as low as \$1.22 -- which he described as fair value -- over the next three to five years.

But the euro's lurch lower has done nothing to change traders like Axel Merk's dim view of the dollar's future.

Based in Palo Alto, California, Merk has been trading for 16 years and is currently president and portfolio manager of Merk Investments, the biggest mutual fund manager dealing exclusively with currencies.

He acknowledges he has had to scramble in his short-term funds to avoid being on the wrong side of the euro's nosedive. But over the next decade and beyond, Merk said the dollar has nowhere to go but down.

Investors will balk at "reckless U.S. fiscal and monetary policies" and start looking for alternatives to the U.S. currency, he said.

Others might take refuge in commodities. A recent U.S. Securities and Exchange Commission filing showed billionaire investor George Soros' New York-based firm more than doubled its bet on the price of gold during the fourth quarter.

Merk, whose \$550 million Hard Currency Fund is designed to profit from a steady dollar decline, said he believes Washington is banking on a gradual dollar devaluation to shrink its monstrous debt and fuel an export boom to propel the economy.

"Now I am convinced that (U.S. authorities) consider a weaker dollar the solution to many of their problems. But you can't turn your policies upside down and expect the rest of the world to put up with it forever."

That view is at odds with the official line from U.S. policymakers. They insist that "a strong dollar is in the U.S. interest," a phrase repeated so often by former Treasury Secretary Robert Rubin in the 1990s it became his mantra. The person in the job today, Timothy Geithner, has made this mantra his own. Treasury officials, who routinely defer to the Treasury chief as the only authorized spokesman for dollar policy, declined to provide comments for this story.

SHARING THE SPOTLIGHT

What's clear is that America's debt-holders aren't the passive, pliant bunch they used to be. Some of the biggest holders of U.S. dollar assets are also among the fastest growing economies and they are hardly bashful about criticizing U.S. policies, particularly now that the financial crisis has eroded America's influence and its reputation for sound economic management.

China alone holds \$2.3 trillion in foreign exchange reserves, with nearly \$800 billion in U.S. Treasury debt. And at a press conference last year, Premier Wen Jiabao did not mince words: "We have lent a massive amount of capital to the United States and of course we are concerned about security of our assets. To speak truthfully, I do indeed have worries."

Terrence Checki, who has acted as the Federal Reserve Bank of New York's chief international trouble-shooter for two decades, warns that the U.S. cannot afford to ignore such concerns.



DEEP DIVE Commentary and Analysis

"We are no longer alone as the central axis for the global economy," he told a gathering of influential bankers and policymakers during a Foreign Policy Association dinner at New York's St Regis hotel in December.

That, he added, implies "recognizing that our leverage will not be what it once was. We also need to be attentive to the messages we receive, such as rumblings about the dollar and our policies and priorities, even when we disagree with them."

History suggests that a currency is supplanted the same way Ernest Hemingway said a man goes broke: gradually, then suddenly. In terms of economic might, the United States surpassed Britain in the late 19th century. But it took another 60 years and two world wars to strip sterling of its reserve status.

Even so, some worry time is not on the United States' side. Emerging markets already account for roughly half of global output and that share is rapidly increasing. In 2003, Goldman Sachs said the size of China's economy would surpass that of the United States by 2041. Five years later, it revised the forecast to 2027. China is expected to surpass Japan as the world's second largest economy this year.

All of which would be fine were it not for the fact that the United States continues to live beyond its means. The recent spike in borrowing and spending following the financial crisis is creating a debt burden that, in the word of Moody's Investors Service, is trending "clearly, continuously upward."

THE KINDNESS OF STRANGERS

For the last 60 years, reserve currency status has conferred upon the United States what former French President Valéry Giscard d'Estaing, during his time as finance minister, called "the exorbitant privilege."

Because the dollar is in high demand, U.S. borrowing costs remain low. That makes it easier for the government to fund domestic priorities and military commitments and the average citizen to buy a home or start a business.

It also means the United States need not borrow or repay debts in foreign currencies, making the value of its currency a less urgent concern than it would be for other borrowers who borrow and pay for imports with dollars.

But such easy access to capital has led to huge deficits. With Americans spending more than they save, the money to finance the shortfalls has to come from abroad.

"We are plainly overextended in our budgetary terms and in our dependence on foreign capital; we resort to the kindness of strangers to meet our deficits," said former Federal Reserve Chairman Paul Volcker at an Economic Club of New York speech last month. Volcker is now head of President Barack Obama's Economic Recovery Advisory Board.

That kindness probably has a limit.

China and Russia have both talked publicly about long-term alternatives to the dollar. Some central banks, including Russia's, have said they intend to hold a greater amount of their foreign exchange reserves in other currencies.

Chinese central bank governor Zhou Xiaochuan also made waves last year when he said the dollar should one day be replaced, perhaps by a "super-sovereign" reserve currency based on Special Drawing Rights, the IMF's in-house unit of account.

Economists have interpreted the comments as an attempt to give the yuan, China's currency, a more prominent role in global finance, in keeping with the nation's growing clout on the world stage.

Of course, that won't happen overnight.

"There might be some progress towards multi-polarization of the international monetary regime, but there will be no immediate change to the dollar's role as the main international currency," said Zhang Zhigang, chief economist with the China Center for

International Economics Exchanges.

But over the last year, China has voted with its pocketbook. It quietly struck currency swap accords worth some 650 billion yuan (\$95 billion) with central banks in Asia, Latin America and Eastern Europe that allow importers to pay for Chinese goods in yuan instead of dollars.

That could set the stage for greater use of the yuan for offshore financial and investment purposes. And that is a precondition if the currency is to achieve greater international status.

For now, however, central bank reserve managers have few options beyond the dollar. No country is close to outranking the United States -- economically, militarily or politically.

The euro, which many see as the dollar's most immediate rival, is tied to an economic area with no common political or fiscal policy. That's part of what makes solving Greece's debt woes so difficult.

It also lacks a common bond market. Veteran Brown Brothers Harriman currency strategist Marc Chandler likens Europe's sovereign bond markets to those for U.S. municipal debt -- lots of issuers of varying size and credit quality, but none that on its own can rival the deep, liquid U.S. Treasury market.

The U.S. Treasury, in an addendum to its October 2009 currency report, cited the disparate sovereign debt markets as the key reason the euro doesn't take an equal share of global reserves, even though the eurozone approximates the United States in economic power.

But other rivals will likely continue to gain strength. Ten years ago, China "was hardly even on the radar screen" in Washington, said Jeffrey Garten, a professor at the Yale School of Management and a former undersecretary of commerce during the Clinton administration.

"So people who say their currency is nowhere near an international currency and that it's going to take at least 20 or 30 years -- I think they're living in a dreamworld," Garten said.

TOWERING DEBT

As they open up and develop their capital markets, emerging economies such as China, Brazil or India could see their currencies occupy a larger portion of central bank reserves in coming decades, according to the October U.S. Treasury report.

It also asserts that as long as the United States maintains sound macroeconomic policies and open, deep and liquid financial markets, the dollar will remain "the major reserve currency." Some worry, however, that the parlous state of U.S. public finances makes betting on long-term dollar dominance dicey. The White House this month said the 2010 budget deficit would reach \$1.565 trillion -- at nearly 11 percent of output, the largest shortfall since World War II.

But America was running large trade and budget deficits before the financial crisis. "We went into the crisis in a weak fiscal position," said C. Fred Bergsten, a former assistant Treasury secretary and current director of the Washington-based Peterson Institute for International Economics.

Dean Baker, co-director of the Center for Economic Policy Research in Washington, said U.S. finances are still manageable and a weaker dollar is necessary to boost exports, cut the trade deficit and end a multi-decade spending binge.

Provided America invests in education and infrastructure, maintains high output and productivity and keeps people employed, he said it can overcome the challenges it faces.

"We are moving to a world that's going to be multi-polar, a world where the dollar is not going to be as dominant as today," he said. "But if we do things to keep the U.S. economy strong, we will be able to finance ourselves going forward."

The United States found ready buyers for roughly \$1.7 trillion in new debt issued in fiscal year 2009, which brought total debt



DEEP DIVE Commentary and Analysis

held by the public to \$7.89 trillion, some 55 percent of output. There are, however, some early signs that buyers may be growing sated. Treasury plans to issue another \$1.5 trillion to \$2 trillion this year -- a record \$126 billion this week alone. Yet auctions for \$41 billion in long-dated debt earlier this month attracted only modest interest. The yield demanded by buyers of fresh 30-year debt was the highest in more than two years. The United States still pays less than 4 percent on its 10-year Treasury notes -- well below an average of 7-9 percent in the 1980s and 1990s. But economists also worry about the government's unfunded pension and health care liabilities. Last year, Dallas Fed President Richard Fisher estimated that the United States may be on the hook for as much as \$99 trillion, much of it tied to Medicare. That's about seven times the size of the entire U.S. economy. "The bottom line is that we can't keep borrowing at this pace forever," said Kenneth Rogoff, Harvard University economist and former chief economist at the IMF. "That only works if the Chinese are willing to lend us unlimited amounts of money at near-zero interest rates, and that just isn't going to last forever." When it ends, Rogoff said the U.S. will have to deal with higher interest rates, higher taxes and slower growth, all of which will further undermine its economic might.

WHEN LEVERAGE ISN'T LEVERAGE

Of course, much as the United States depends on Chinese savings to finance its deficit, China depends on U.S. consumers to keep buying its exports.

Few think this mutual dependence can last indefinitely. U.S. authorities and a number of economists claim the problem is China's inflexible exchange rate that pegs the yuan to the dollar, thus keeping it undervalued to support exports.

Analysts at the Washington-based Peterson Institute say that given China's massive growth, the yuan may be undervalued against the dollar by as much as 40 percent.

Since President Barack Obama assumed office, the U.S. has twice declined to label China a currency manipulator, a move that could trigger trade sanctions. But the administration has repeatedly complained of China's unfair trade advantage.

Recently, the White House even pledged to double U.S. exports in five years, a goal that economists say would require a signifi-

cantly weaker dollar.

It's not clear how much other nations, particularly China, will go along.

In the post-Cold War era, currency talks are the rough equivalent of nuclear arms reduction negotiations. In language evocative of the U.S.-Soviet face-off, Chinese military officers have proposed punishing Washington with "a strategic package of counter-punches" that includes dumping U.S. government bonds.

While the military plays no role in setting China's foreign exchange holdings, the comments underscored the rising level of tension and mistrust between the two powers.

Nicholas Lardy, a senior Peterson Institute fellow, dismisses such threats, noting that China's vast dollar wealth would start to evaporate and its currency to rise if it started unloading Treasuries.

"The Chinese are in the classic dollar trap. They have so many dollars that they can't diversify," he said.

Marc Leland, head of Leland & Associates and deputy undersecretary of the Treasury during the first Reagan administration, said: "It's only leverage if one thinks they can pull the trigger. I don't think they can."

Morgan Stanley Asia chairman Stephen Roach isn't so sure. He said that if the U.S. eventually resorts to trade sanctions against China -- not unthinkable in a U.S. election year, with the unemployment rate near 10 percent -- Beijing would likely retaliate.

China might boycott a Treasury auction, he said, which could cause the dollar to plummet and interest rates to spike.

"I spend a lot of my time talking to the Chinese about that, and if it happened, I think they would feel compelled to stand up and take strong retaliatory actions, even though, yes, there would be consequences for them as holders of Treasuries and other dollar-denominated assets," Roach said.

Merk, the investor who is betting against the U.S. currency, said the dollar's future may depend on Washington assuming a more humble attitude.

"Once you believe that you are better and greater than everyone else, you have a problem," he said, "because today, the competition is right around the corner."

That may be especially true for any winner of a reverse beauty contest.

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