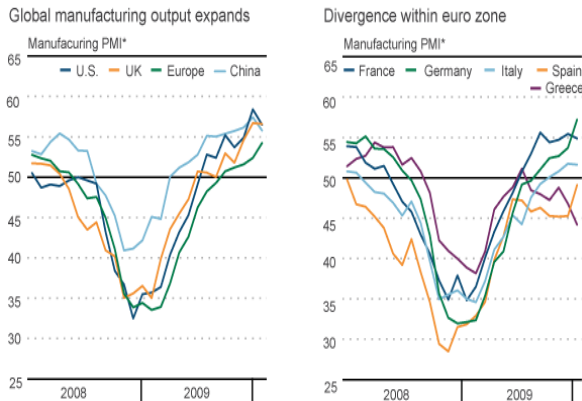


## CHART OF THE DAY

### Global manufacturing PMI



Factories around the world enjoyed a bumper February with business surveys showing the manufacturing sector in major economies continued to lead an economic recovery, despite a slowdown in some growth rates.

## TODAY'S TOP NEWS

- UK's Pru to buy AIG Asia for \$35.5 billion
- U.S. consumer spending up, manufacturing grows
- Fannie, Freddie special refinance program extended
- Greece must do more to tackle debt crisis, EU says
- Buffett: Health care "tapeworm" drags on economy
- Raise taxes, cut spending to balance U.S. budget
- U.S. bank regulator warns on quick capital rules
- Shelby counters on financial consumer watchdog
- Euro zone factory growth speeds up; Spain, Greece lag
- Canada delivers golden Q4 economic performance

## ECON WATCH FOR TUESDAY MARCH 2

ET	Indicators	Unit	Reuters	Prior
05:00	EZ Inflation, flash yy	%	1.0	1.0
05:00	EZ Producer prices mm	%	0.6	0.1
05:00	EZ Producer prices yy	%	-1.1	-2.9
05:00	IT Consumer price prel mm	%	0.2	0.1
05:00	IT Consumer price prel yy	%	1.3	1.3
05:00	IT HICP prelim mm	%	0.2	-1.5
05:00	IT HICP prelim yy	%	1.3	1.3
09:00	CA BoC rate decision	%	0.25	0.25
18:59	US Domestic car sales	mln	3.70	3.80
18:59	US Domestic truck sales	mln	4.20	4.18
18:59	US Total Vehicle Sales	mln	10.50	10.78

## MARKETS TODAY

**TODAY'S TOP STORY:** Britain's Prudential will buy AIG's Asian arm for \$35.5 billion in the insurance sector's biggest deal ever, helping the bailed-out U.S. group repay a big chunk of its taxpayer debt.

**For more please click here**

**TREASURIES:** U.S. government debt prices ended flat to slightly higher as investors' anxiety over the economy supported a safety bid for bonds and offset a rally on Wall Street.

- 10-yr Treasury prices rose 3/32 to yield 3.61 pct from 3.62 pct late on Friday, while two-yr notes rose 1/32 to yield 0.80 pct from 0.82 pct.
- 30-yr bonds were 2/32 higher in price to yield 4.56 pct, while five-year notes was up 3/32 yielding 2.29 pct from 2.31 pct.

**FOREX:** The euro fell against the U.S. dollar, led by a sharp sell-off in sterling and lingering uncertainty over a bailout for debt-strapped Greece.

- Euro fell 0.47 pct to \$1.3559 after hitting a session low of \$1.3461.
- The euro shed 0.21 pct to 120.79 yen.
- The sterling was down 1.14 to \$1.4983. At current prices, it's on track for its biggest one-day decline since late October 2009. It had tumbled as low as \$1.4781.
- Dollar was up 0.27 pct to 89.09 yen and was down 1.22 pct down against the Canadian dollar at C\$1.0417.

**CORPORATES:** U.S. corporate bond spreads tightened, led mostly by the financial sector but also on encouraging signs that debt-strapped Greece may be close to an aid deal with European Union members.

- The CDX.IG-13 index tightened by about 3 bps to 89 bps.
- Five-year CDS on Prudential widened by 30 bps to around 110 bps.
- Merck five-year CDS widened by 22 bps to 87 bps.
- Goldman Sachs sold \$2.0 bln of 10-yr notes.
- Republic Services Inc sold a \$1.5 bln two-part offering.

**STOCKS:** U.S. stocks rose for a second straight day, boosted by AIG's record-setting deal to sell a major Asian unit and on gains in semiconductor shares after SanDisk Corp raised its revenue forecast.

- AIG jumped 4.08 pct to \$25.78 after Prudential agreed to buy its AIA Group insurance arm of Asia for \$35.5 billion.
- Dow gained 0.76 pct to 10,403.79, S&P added 1.01 pct to 1,115.7 and Nasdaq rose 1.58 pct to 2,273.57.
- U.S. listed shares of National Bank of Greece rose 2.33 pct to \$3.95.
- The NYSE Arca Biotech index jumped 5.70 pct, led by OSI Pharmaceuticals, which advanced 51.94 pct to \$56.25 after Japan's Astellas Pharma Inc launched a \$3.5 billion hostile bid for the company.
- SanDisk climbed 11.94 pct to \$32.63. The PHLX Semiconductor index added 3.13 pct.

**C & E:** Oil fell in choppy trade as investors sold off a rally above \$80 a barrel and the dollar strengthened against the euro.

- U.S. crude prices shed 1.14 pct to \$78.75 per barrel.
- Gold was up 0.08 pct to \$1,117.05 an ounce.
- Reuters-Jefferies index was down 0.75 pct at 272.71.

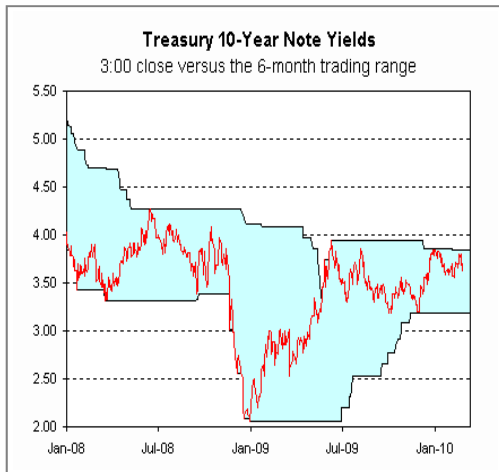
• For MARKET SNAPSHOT click here

• 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	0.085	0.05	0.086	-0.007
3-Mo Bill	0.125	0.115	0.127	0.006
6-Mo Bill	0.180	0.170	0.183	-0.002
1-Year	0.290	0.288	0.295	0.002
2-Year	100.125	100.156	0.812	0.023
3-Year	100.141	100.172	1.327	0.047
5-Year	100.398	100.445	2.290	0.102
7-Year	99.703	99.750	3.047	0.086
10-Year	100.109	100.172	3.612	0.078
30-Year	101.078	101.156	4.559	0.023

EQUITIES

	INDEX	CHANGE
DJIA	10390.26	65.83
NASDAQ	2268.26	30.04
S&P 500	1113.93	9.30

OIL

	PRICE	CHANGE
NYMEX	78.6	-1.1
BRENT	76.8	-0.8

EURODOLLAR FUTURES

	CLOSE	CHANGE
Mar-10	99.740	0.005
Jun-10	99.665	0.015
Sep-10	99.495	0.010
Dec-10	99.200	0.005

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.230	O/N	0.240
2-Week	0.220	2-Week	0.220
1-Month	0.210	1-Month	0.220
3-Month	0.220	3-Month	0.240
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX	
O/N	0.230	10:00 AM	0.170
2-Week	0.220	3:00 PM	0.173
1-Month	0.220		
3-Month	0.230		

IR SWAPS <19901>

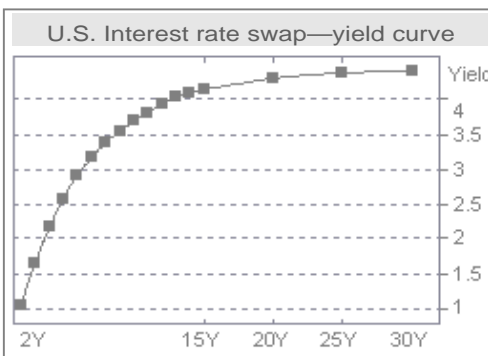
	SPREAD		RATE	
2-Year	22.50	26.50	1.03	1.05
3-Year	30.50	34.50	1.63	1.64
5-Year	27.00	31.00	2.56	2.56
7-Year	10.75	14.75	3.15	3.15
10-Year	5.75	9.75	3.67	3.65
30-Year	-16.25	-12.25	4.39	4.37

FUTURES

	PRICE	CHANGE
CBOT 5 yr	117.03	-0.02
CBOT 10 yr	118.88	-0.03
CBOT 30 yr	118.97	-0.22

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.140	0.160	-	-
1-Month	0.200	0.280	0.135	0.145
3-Month	0.220	0.400	0.149	0.159
6-Month	0.250	0.450	0.171	0.181
12-Month	0.600	1.000	0.293	0.303



CURRENCIES

	BID	ASK
Euro	1.3569	1.3572
Sterling	1.4999	1.5004
JP Yen	89.08	89.10
Swiss Franc	1.0783	1.0786
Can Dollar	1.0410	1.0416
Mexico	12.7431	12.7492

FED FUNDS NYFR<sup>SM</sup> - 10AM

Open	0.1500	1m	0.2156
High	0.1500	3m	0.2525
Low	0.0800		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1	04/04/2012	20	19.5	1.02
3-Year	1.375	09/01/2013	14	13	1.48
5-Year	2.875	09/02/2015	27	26	2.55
7-Year	5.125	18/10/2016	34.75	34	3.39
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	34.75	34.25	4.91

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	1	0	0.83
3-Year	1.75	22/02/2013	21	20.5	1.53
5-Year	2.625	20/11/2014	15.5	14.5	2.44
7-Year	5.25	15/09/2016	40.25	39.5	3.45
10-Year	3.75	27/03/2019	19	18.5	3.8
30-Year	6.25	15/07/2032	34.25	33.75	4.9

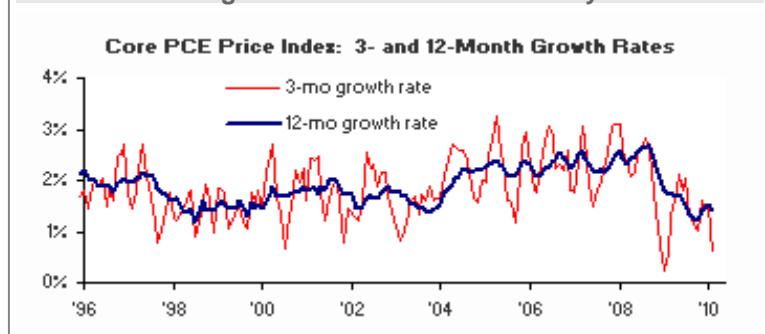
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.1500	105.1700	2.591
FHLMC	5.0	105.1500	105.1700	2.591

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.1100	105.1300	3.024
FHLMC	5.5	105.2300	105.2500	2.818
GNMA	5.5	105.2400	105.2600	3.514

Wrightson ICAP<sup>SM</sup> Chart of the Day



## TODAY'S TOP NEWS

**UK's Pru to buy AIG Asia for \$35.5 billion**

Britain's Prudential will buy AIG's Asian arm for \$35.5 billion in the insurance sector's biggest deal ever, helping the bailed-out U.S. group repay a big chunk of its taxpayer debt.

Britain's No. 1 insurer said it would finance the buy through a rights issue of \$21 billion including costs and fees, a record for an acquisition-related cash call, and by raising \$5 billion of debt. Buying AIA will lift the proportion of Prudential's new business profit generated in Asia to 60 percent from 44 percent, while roughly trebling its Asian customer base to 30 million, the company said.

Investors and analysts said they needed to know more about AIA before they can judge whether the takeover justifies the rights issue, whose proceeds will nearly equal Prudential's current market value of about \$23 billion.

AIG will use \$16 billion of the cash portion of the sale proceeds to pay the Federal Reserve Bank of New York for its stake in a special purpose vehicle that holds AIA. The remaining \$9 billion of proceeds will be used to pay down the Fed's credit facility. Under the deal, AIG will also receive \$10.5 billion in Prudential shares, giving it a stake of about 11 percent, which it plans to sell to further reduce its borrowings. The rights issue is expected to be completed in June, and it is a "reasonable assumption" that the new shares will be offered at a discount of about 40 percent, Prudential Chief Executive Tidjane Thiam said.

**Fannie, Freddie special refinance program extended**

An Obama administration program aimed at helping homeowners whose homes have declined in value get new loans has been extended another year, a key housing regulator said.

The HARP will stay in effect through June 30, 2011, the FHFA said in a statement.

The housing regulator said about 190,180 mortgages have been refinanced since HARP was launched in April of last year. Of those refinancings, just 1,923 mortgages were between 105 and 125 percent of the home's value and 188,257 were for mortgages between 80 percent and 105 percent of the home's value. Fannie Mae and Freddie Mac have refinanced more than 4 million loans while HARP has been running.

The announcement comes just days after lawmakers in both parties sharply criticized the administration's efforts to help struggling homeowners, particularly the higher profile HAMP.

Rep. Dennis Kucinich, who chairs the House Oversight and Government Reform Domestic Policy Subcommittee, told Caldwell he was giving her "a wake-up call" to do more to help homeowners.

**Buffett: Health care "tapeworm" drags on economy**

Warren Buffett said "out of control" health care costs are a "tapeworm" limiting growth in an economy recovering only fitfully from the financial crisis.

The world's second-richest person called on Washington policymakers to adopt fundamental reforms on such costs to address what he called a "national emergency."

He said health care eats up 17 percent of U.S. GDP, at a time when many other countries pay only nine or 10 percent of GDP but have more doctors, nurses and hospital beds per capita.

Rising costs, Buffett said, are holding back an economy that faced an "economic Pearl Harbor" in late 2008 when capital markets seized up. While he said "we got past Pearl Harbor" and "we will win the war," he said the recovery remains slow, including in many businesses at his insurance and investment company Berkshire Hathaway Inc.

**U.S. consumer spending up, manufacturing grows**

U.S. consumer spending increased slightly faster than expected in January while the U.S. manufacturing sector grew, underscoring views economic recovery is progressing.

The Commerce Department said spending rose 0.5 percent, after advancing by an upwardly revised 0.3 percent in December. Analysts polled by Reuters had expected consumer spending to increase 0.4 percent in January.

An industry report said the U.S. manufacturing sector grew in February but at a slower rate than was expected.

ISM said its index of national factory activity declined to 56.5 in February from 58.4 in January. The median forecast of 80 economists surveyed by Reuters was for a reading of 57.5.

Another report showed U.S. construction spending fell for a third straight month to its lowest level since June 2003 in January.

Consumer spending rose at a modest 1.7 percent annual rate in the fourth quarter from 2.8 percent in the prior period.

Spending adjusted, rose 0.3 percent in January, picking up from a 0.1 percent gain the prior month. Personal income edged up 0.1 percent, a month after increasing 0.3 percent in December.

Real disposable income fell 0.6 percent in January, the largest decline in seven months. The drop in income pulled the savings rate down to an annual rate of \$367.2 billion, the lowest level since February 2009.

**Greece must do more to tackle debt crisis, EU says**

Greece needs to take further action quickly to tackle its debt crisis and meet its budget goals, European Union Economic and Monetary Affairs Commissioner Olli Rehn said.

Rehn said he sensed a "strong determination" by the Greek government to reform the country but said additional measures were needed as soon as possible if Greece was to solve the country's debt crisis.

Finance Minister George Papaconstantinou said plans to deal with Greece's debt burden involved "dangers and risks and some of these dangers are now visible" but the government would not waver in its commitment to reducing the deficit.

Prime Minister George Papandreou earlier called on citizens to bear the pain required to put the country back on track, saying corruption and impunity were at the heart of its problems.

Separately, Germany has moved to identify speculators in Greek debt to try to prevent them from profiting from any bailout of the euro zone country's ailing economy, a source with direct knowledge of the matter told Reuters.

**Raise taxes, cut spending to balance U.S. budget -Hoyer**

Tax increases and spending cuts will both be needed to spread the burden of bringing down U.S. budget deficits to a sustainable level, House of Representatives Democratic leader Steny Hoyer said.

Hoyer's remarks frame a debate that is likely to pick up urgency as a bipartisan panel created by President Barack Obama considers ways to balance the budget.

"A balanced approach would spread the effects of change across American society," Hoyer said.

Republicans have said that tax increases should be off the table, while many Democrats have resisted cuts to expensive but popular entitlement programs.

Hopefully, voters will support those who back a plan that causes short-term pain to head off fiscal catastrophe, Hoyer said.

A separate report showed, Fed Vice Chairman Donald Kohn, will step down in late June, giving President Barack Obama a freer hand to reshape the institution.



## TODAY'S TOP NEWS

**U.S. bank regulator warns on quick capital rules**

The regulator of the largest U.S. banks said policymakers should not impose steep new capital requirements too soon, which could choke off lending just as the economy is beginning to recover. Comptroller of the Currency John Dugan said that there was a "real tension" between putting critical capital and liquidity reforms in place, and ensuring that institutions are extending credit.

However, he said his preference was to focus more on long-term reforms, while still being cognizant of short-term credit.

Dugan's comments come as international regulators and lawmakers craft reforms designed to prevent another severe financial crisis like the one that gripped the world in 2008 and toppled some of the top global investment banks, including Bear Stearns and Lehman Brothers. Separately, large participants in the \$450 trillion, privately traded derivative markets gave new commitments to regulators, as part of efforts to expand transparency and central clearing of the contracts.

**Sen Shelby counters on financial consumer watchdog**

A senior Republican U.S. senator has made at least two counter-offers to Democrats on creating a new government watchdog for financial consumers, Reuters learned from aides and documents.

Senator Richard Shelby proposed making the watchdog a division of the FDIC, with some rule-writing power and a director who is appointed by the president and confirmed by the Senate, documents showed.

Shelby also has proposed setting up a three-member consumer protection council, said a congressional aide.

Both offers show that negotiations between Shelby and Senator Christopher Dodd on a bipartisan financial regulation reform bill are in full swing, but still have some ground to cover.

After marathon talks over the weekend, lawmakers remained snagged on how much rule-writing power the new watchdog should have, no matter where it is located within the government. Financial regulation has changed little in the face of stiff resistance from banks and Wall Street.

**Euro zone factory growth speeds up; Spain, Greece lag**

Manufacturing activity in the euro zone grew slightly faster than previously thought last month but Spain and Greece continued to lag far behind the bloc's big three economies, a survey showed.

The Markit Eurozone Manufacturing PMI's for February jumped to 54.2 from 52.4 in January, nudging up from a flash estimate of 54.1 released late last month.

The output index notched up a near 3-year high, rising to 57.0 from January's 56.0.

Earlier data from Germany, showed activity there expanded at its fastest pace in 32 months while in Italy the PMI was just shy of January's 28-month high. The France PMI slipped to 54.9.

In Spain, manufacturing activity contracted for the 27th month, although was closer to stabilizing.

The Spanish PMI jumped to 49.1 from January's 45.3. Business conditions for Greek manufacturing worsened in February, with the index falling to a 10-month low of 44.2.

**Canada delivers golden Q4 economic performance**

Canada reported sizzling fourth-quarter economic growth, blasting away lingering doubts about recovery from recession and putting pressure on the Bank of Canada to raise interest rates sooner than it had planned.

Strong consumer spending, housing demand and exports boosted gross domestic product by 5 percent at an annualized rate, Statistics Canada said. That was the strongest rate since 2000 and well above the 4.1 percent market forecast.

Statscan revised its calculation of growth in the third quarter to 0.9 percent from 0.4 percent previously.

The federal agency also reported a rise in producer prices and raw materials prices in January from December due to rising oil prices. The fourth-quarter revival was not enough to offset the impact of a grueling recession that caused GDP in 2009 to shrink 2.6 percent overall from 2008. In the separate report, Statscan said a recovery in oil prices pushed up Canadian producer prices by 0.3 percent in January from December and raw materials prices climbed 3.3 percent for the same reason.

## NEXT UP

**Brake for payrolls, eye on Greece**

U.S. Treasuries will likely trade in a narrow range as the market pauses before keenly watched U.S. payrolls data due at the end of the week.

The absence of fresh supply of Treasury notes this week is supportive for bond prices. Weighing against Treasuries is talk of solutions to Greece's debt and fiscal issues. Such talk tends to damp the bid for safe-haven U.S. government debt.

European Economic and Monetary Affairs Commissioner Olli Rehn said the euro zone stood ready to take coordinated action to support Greece.

Weekly store sales figures will likely be hard to interpret in light of last week's severe winter weather in some parts of the country. Monthly vehicle sales will get attention, but are unlikely to move the Treasury market. But until Friday's employment data, Treasuries will likely confine themselves to a narrow range.

In Reuters' latest poll, analysts predicted U.S. employers shed a total of 50,000 jobs in February, more than the 20,000 cut in January.

The jobless rate likely edged up to 9.8 percent from a five-month low of 9.7 percent in January.

**Bank of Canada seen holding rates steady March 2**

All 12 primary securities dealers surveyed by Reuters expect the Bank of Canada to maintain its overnight target rate on Tuesday at 0.25 percent. Nine of the 12 forecast the bank will follow through on its conditional pledge to hold rates at their current level until the end of June, with one seeing the first hike in April and two expecting a hike in June.

All think the bank will raise rates at some point this year, with forecasts for the year-end rate ranging from 0.75 percent to 1.75 percent. Yields on overnight index swaps showed investors expect the bank's overnight rate to rise to around 0.50 percent by September whereas a week ago they expected rates to reach that level by July.

Markets are eager for guidance from the bank on how soon it thinks rate tightening is needed. The bank may take a cue from Bernanke and dampen incipient market talk of an early rate hike. Canada's central bank has said it plans to keep rates on hold until the end of June but that pledge is conditional on inflation following a desired path. In the unlikely case that the bank wants to abandon that plan, it would likely signal that shift in March or April.



DEEP DIVE Commentary and Analysis

**COLUMN-Correlations change commodity asset class**

By John Kemp

Commodities are losing their portfolio diversification property as prices for a wide range of raw materials (farm products as well as energy and industrial metals) become increasingly correlated with one another and financial assets such as equities.

The altered behavior of prices since 2008 calls into question the rationale that made commodities popular with institutional investors in recent years, and casts doubt on their status as an alternative asset class that can reduce the overall risk in a portfolio.

Daily price changes and volatility for many raw materials included in the Standard and Poors'-Goldman Sachs and Dow Jones-UBS indices show increasing integration with one another and with the S&P 500 equity index. Only coffee and sugar appear to be behaving independently as traditional markets dominated by specific supply and demand factors rather than reacting to generalized views about the business cycle and investors' appetite for risk.

Correlations between U.S. equity indices (such as the S&P 500) and major energy and industrial raw materials markets (such as crude oil and copper) are not surprising. Both energy consumption and the use of manufacturing inputs such as copper are strongly geared to the business cycle. What has been unusual is how tight the correlations have become in the last two years and how long they have lasted.

But heightened correlations have not been confined to manufacturing inputs. They have spread to a broad range of farm products (including cotton, livestock, lumber and cocoa) that have no direct link to manufacturing, suggesting something more than a business cycle is at work.

**INCREASING CO-MOVEMENT**

The first set shows correlations between daily price changes (measured on a close-to-close basis). It captures how often a rise (fall) in equity or oil prices is accompanied by a similar rise (fall) in other commodities in the same direction.

The second focuses on volatility (again measured on a close-to-close basis). It shows how often a large (small) movement in equity or oil prices is accompanied by a similarly large (small) movement in other commodity prices (whether in the same direction or not).

These are micro rather than macro correlations. By focusing on day-to-day price and volatility changes both sets ignore the overall level of prices (linked to the cycle) to focus on how far other commodity markets are responding to the same sort of shocks as crude oil and equities.

Looking at the daily price changes in the first set of charts, correlations between crude oil, copper and equities (around 0.6) are much higher than for coffee (0.4), cocoa (0.35), cotton

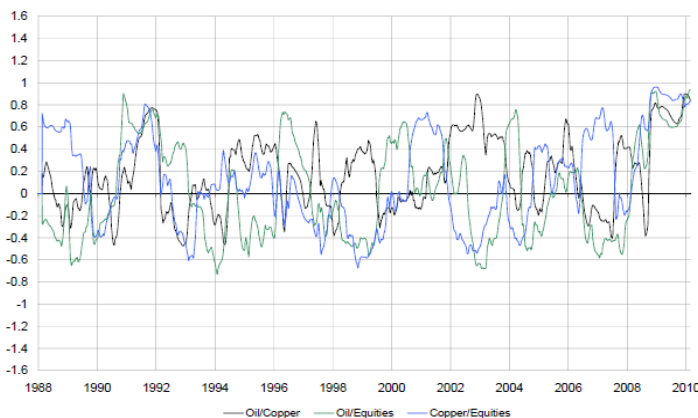
(0.35), sugar (0.30), cattle (0.2) and lumber (0.2). But in every case, correlations have risen significantly since the start of 2008 and in most cases are now at the highest level seen for more than 20 years.

Prices for copper and oil appear strongly influenced by the same common factor(s) that are driving the equity market.

Coffee, cocoa and cotton are somewhat influenced, while sugar, cattle and lumber show only a marginal impact from these common factor(s). But in every case the common factor(s) influence has become far stronger in the past two years.

Turning to volatility, a very similar pattern emerges. The amount of volatility in oil and copper prices has become closely and

CROSS-MARKET VOLATILITY CORRELATIONS  
30-DAY ANNUALISED VOLATILITY



durably linked to volatility in the equity market (with a correlation coefficient at 0.80 or higher). Volatility in lumber and cocoa also appears to be tracking equities unusually closely. In other markets, correlations are lower and in some cases have fallen in recent weeks. But most commodities have shown historically strong correlations for much of the last two years, persisting well beyond the peak of the financial crisis in 2008-2009.

Overall, oil and copper appear to be the most closely integrated with one another and with equities, and the degree of integration has risen significantly since 2008. Cotton, lumber, cattle and cocoa prices are also modestly integrated and the degree of co-movements has risen significantly in each case. Coffee and sugar are the least integrated and display a strong market-specific tendency in price formation. But even here, there are signs that co-movement is increasing, albeit from a very low level.

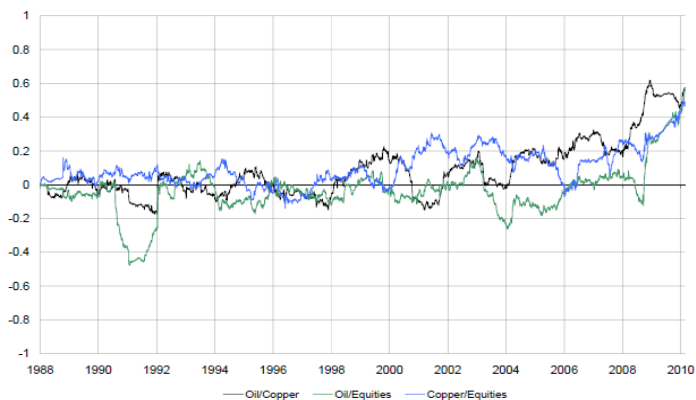
**SOURCES OF INTEGRATION**

Correlation does not imply causation, and the reasons for this increased integration are controversial. But the increase in correlations across so many different commodities; the scale of the rise in each case; its persistence; and the common timeframe (starting in 2008), suggests there is something that needs explaining.

Rather than a distinctive, alternative class of assets which respond mostly to market-specific changes in supply and demand, commodities increasingly seem to be integrated into the wider constellation of financial assets (including equities, bonds and currencies), subject to the same ebb-and-flow of hope and fear, expectations about the cycle, and risk aversion.

The reasons why so many commodities have become integrated with other markets are not immediately clear. Integration may be a temporary, cyclical phenomenon that will pass as financial conditions become more normal. Or it may reflect structural changes in the way commodities are traded that will cause the linkages to become tighter on a permanent basis.

CROSS-MARKET CORRELATIONS  
DAILY PRICE CHANGES



## DEEP DIVE Commentary and Analysis

## LINKED BY LIQUIDITY?

Integration may be a symptom of the unusual severity of the current cycle and the heightened role liquidity is playing across all markets. The unprecedented decline in manufacturing activity and evaporation of liquidity undoubtedly contributed to the unusually sharp and synchronized decline in all markets during H2 2008 and H1 2009. In turn, the massive injection of liquidity by the major central banks and associated turning point in the manufacturing cycle is now lifting all asset classes.

If it was the evaporation and subsequent inundation of liquidity that forged closer links between commodity prices and other markets, these links might be expected to weaken as central banks start to tighten policy and liquidity conditions "normalize". As conditions return to normal, market-specific fundamentals should reassert themselves.

## LINKED BY INVESTORS?

But the other explanation focuses on more structural changes, in particular the increased role played by hedge funds, institutional investors and other "financial" participants in price formation. Financial participants are more likely to operate in other markets (equities, bonds and currencies) and trade commodities as part of a multi-asset strategy. As their role increases relative to traditional producers and consumers, commodity prices are more likely to respond to the same sort of shocks and news flow

that drive other classes. Negative news that causes financial participants to cut exposure in their equity holdings may also cause them to sell other pro-cyclical assets such as commodities.

Moreover, positions in many individual commodities are held as part of a larger commodity "basket." If financial participants add or reduce their exposure to the basket as a whole, it would help explain why commodity prices appear increasingly integrated with one another as well as with other asset classes such as equities.

The most likely explanation combines both cyclical and structural factors. There is no doubt the panic of 2008 and subsequent flood of cheap money has swamped other effects; a rising tide has lifted all boats. As conditions normalise, the links are likely to soften and asset prices will be more differentiated.

But the way in which commodities are traded and priced has also changed. These are no longer raw materials traded on a short horizon (up to twelve months) but assets traded and priced with a longer term (one- to five-year) view based primarily on the business cycle. While close correlations witnessed since 2008 may soften, they are likely to remain much stronger than in the past.

-- John Kemp is a Reuters columnist. The views expressed are his own --

INSIDE DEBT is produced by Reuters in partnership with ICAP.

(Compiled by Anil Kumar and Pronita Naidu in Bangalore)

For questions or comments about this report, email us at:

[inside.debt@thomsonreuters.com](mailto:inside.debt@thomsonreuters.com)

or contact Chandra Ramarathnam on +91 80 4135 5899

For Market Snapshot, ICAP provides OTC capital markets data, Thomson Reuters provides exchange data.

Visit the Thomson Reuters Fixed Income Community Site at:

<http://customers.reuters.com/community/fixedincome/>

If you like to receive this in your mailbox, please subscribe at:

<http://interact.thomsonreuters.com/insidedebtdaily/>

For more information about our products:

[http://thomsonreuters.com/products\\_services](http://thomsonreuters.com/products_services)

Or send us a sales enquiry at: <http://reuters.com/salesenquiry>

North America: +1 800.541.2268



## ICAP:

For additional information and to find out more about how ICAP's range of market information, commentary and research solutions can help your business, contact [icapinformationservices@icap.com](mailto:icapinformationservices@icap.com).  
Americas: +1 212 341 9789

© Thomson Reuters 2010. All rights reserved. Thomson Reuters and the logo are the trademarks or registered trademarks of the Thomson Reuters group of companies around the world

ICAP plc, its subsidiaries ("ICAP") and third parties own portions of the copyright to information, data and content ("Information") and to certain service marks and logos herein. The Information is for informational purposes only; is not intended as investment, financial or accounting advice; and should not be construed as an offer, bid or solicitation in relation to any financial instrument. All information is provided "as is" without any representations or warranties of any kind. ICAP and third parties shall not be responsible or liable for any damages whatsoever arising out of or relating in any way to the Information herein.

