

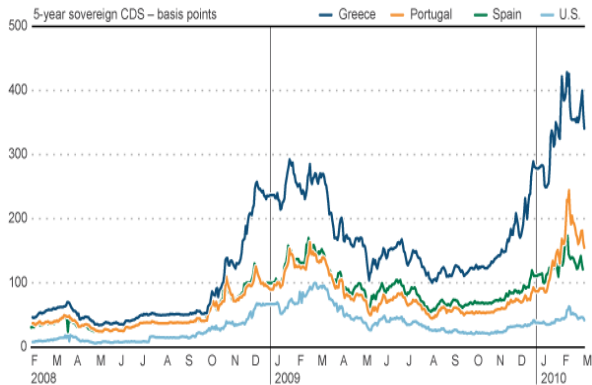
INSIDE DEBT

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Tuesday, March 2, 2010

CHART OF THE DAY

Global sovereign credit default swaps



Greece's borrowing costs fell to their lowest level in weeks amid growing expectations that the government will announce new austerity measures that will help it secure European financial support.

TODAY'S TOP NEWS

- EU urges new Greek cuts, cabinet to meet on Weds
- FDIC seen stepping up sales of failed bank assets
- Obama proposes \$3,000 home energy rebates
- Fed's Hoenig-Zero rate pledge invites speculation
- New Basel rules could hit synthetic CDOs -Goldman
- Fitch may cut Prudential Plc's ratings on AIG deal
- Abu Dhabi readies roadshow for new debt issues
- Euro zone inflation below consensus, seen subdued

ECON WATCH

FOR WEDNESDAY MARCH 3

ET	Indicators	Unit	Reuters	Prior
02:00	DE Retail sales mm real	%	-0.5	0.9
03:43	IT Markit/ADACI Svc PMI	ind	50.8	50.9
03:48	FR Markit/CDAF Svc PMI	ind	54.7	56.3
03:53	DE Markit Svc PMI	ind	51.7	52.2
03:58	EZ Markit Svc PMI	ind	52.0	52.5
03:58	EZ Markit-composite PMI	ind	53.7	53.7
04:28	GB CIPS/Markit Serv PMI	ind	54.9	54.5
05:00	EZ Retail sales mm	%	-0.4	0.0
05:00	EZ Retail sales yy	%	-1.6	-1.6
07:00	US Mortgage market index	ind	-	549.5
07:00	US Mortgage refi index	ind	-	2605.3
07:30	US Challenger layoffs	ind	-	71.482
08:15	US ADP Nat Employment	k	-20	-22
10:00	US ISM N-Mfg PMI	ind	51.0	50.5
10:00	US ISM N-Mfg Bus Act	ind	52.8	52.2
14:00	US Fed Beige Book	-	-	-
-	GB BoE starts 2-day Monetary Policy Meet	-	-	-

MARKETS TODAY

TODAY'S TOP STORY: The European Union urged Greece to agree additional austerity measures within days to tackle a fiscal crisis that has shaken the euro zone and promised to help Athens overcome its debt problems. **For more please click here**

TREASURIES: U.S. Treasuries eased, ending three days of price gains, as the safe-haven allure of government debt was undermined by rising optimism Greece would reach a financial aid deal with the European Union.

- 30-yr bond prices fell 6/32 to yield 4.57 pct.
- 10-yr Treasury were unchanged yielding 3.61 pct, while the 2-yr notes rose 1/32 to yield 0.79 pct.
- 5-yr Treasury notes were up 3/32 to yield 2.27 pct.

FOREX: The euro rebounded from a 9-1/2-month low against the dollar as investors awaited new plans to address Greece's debt crisis and held out hope for some type of help from the European Union.

- Euro rose 0.38 pct to \$1.3606, near a session peak of \$1.3617 and well off its \$1.3435 session low. Euro briefly hit a session high of 1.4653 against the Swiss franc.
- The dollar fell 0.43 pct to 88.73 yen. Sterling was down 0.19 pct to \$1.4957. The dollar index shed 0.19 pct to 80.502.
- Australian dollar rose 0.28 pct to \$0.9034.

CORPORATES: U.S. corporate bonds spreads tightened as signs of progress in securing European financial support for Greece relieved investor fears.

- The CDX.IG-13 index widened by about 1 bps to 90 bps.
- KEXIM launched \$1.0 bln of 5.5-yr notes.
- South Africa sold \$2 bln of 10-year notes.
- The divergence between CDS of BofA and its Merrill Lynch unit has narrowed to about 9 bps from 30 bps about a month ago.
- Moody's Investors Service kept a positive outlook on Chile's A1 sovereign ratings even as it expects the economy to slow down this year following a devastating earthquake.

STOCKS: U.S. stocks headed for a third straight day of gains as investors drew cheer from more mergers and acquisitions and signs of progress in securing European financial backing for Greece.

- Dow rose 0.02 pct to 10,405.98, S&P was up 0.23 pct to 1,118.30 and Nasdaq gained 0.32 pct to 2,280.79.
- Earlier, the CBOE Volatility Index fell more than 3 pct to 18.64.
- Dow Chemical Co shares were up 0.66 pct to \$28.88, as it said it would sell its Styron basic plastics unit to Bain Capital Partners for \$1.63 bln.
- Qualcomm Inc rose 6.66 pct to \$37.93.

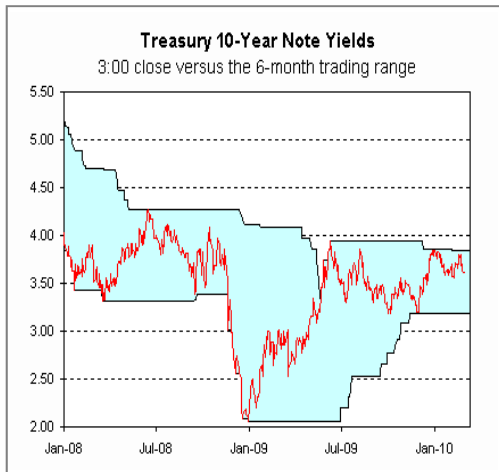
C & E: Oil jumped as the euro bounced against the dollar and Wall Street strengthened as Europe tried to deal with debt-laden Greece.

- U.S. crude prices was up 1.3 pct to \$79.72 per barrel.
- Gold rose 1.38 pct to \$1,133.8 an ounce.
- Reuters-Jefferies index gained 0.89 pct at 275.13.

- 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	0.095	0.06	0.096	0.016
3-Mo Bill	0.135	0.125	0.137	0.004
6-Mo Bill	0.185	0.180	0.188	0.001
1-Year	0.290	0.288	0.295	-0.003
2-Year	100.141	100.172	0.804	0.016
3-Year	100.156	100.188	1.321	0.016
5-Year	100.461	100.508	2.277	0.059
7-Year	99.750	99.797	3.040	0.047
10-Year	100.078	100.141	3.615	-0.023
30-Year	100.891	100.969	4.570	-0.156

EQUITIES

	INDEX	CHANGE
DJIA	10419.20	15.41
NASDAQ	2282.70	9.13
S&P 500	1119.89	0.00

OIL

	PRICE	CHANGE
NYMEX	79.9	0.7
BRENT	77.8	0.9

EURODOLLAR FUTURES

	CLOSE	CHANGE
Mar-10	99.743	0.005
Jun-10	99.670	0.005
Sep-10	99.505	0.000
Dec-10	99.220	0.000

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.210	O/N	0.230
2-Week	0.220	2-Week	0.220
1-Month	0.220	1-Month	0.220
3-Month	0.220	3-Month	0.230
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.230	10:00 AM	0.150
2-Week	0.210	3:00 PM	0.149
1-Month	0.210		
3-Month	0.250		

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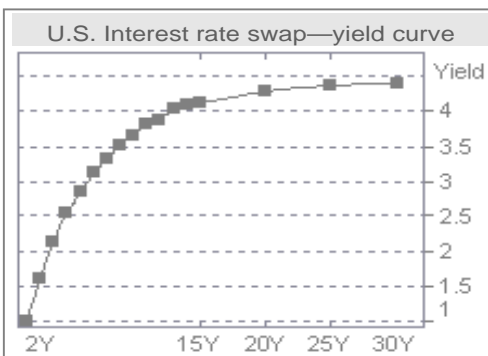
	SPREAD		RATE	
2-Year	22.00	26.00	1.02	1.04
3-Year	29.50	33.50	1.61	1.63
5-Year	26.50	30.50	2.54	2.54
7-Year	10.00	14.00	3.14	3.13
10-Year	4.25	8.25	3.65	3.64
30-Year	-17.25	-13.25	4.40	4.37

FUTURES

	PRICE	CHANGE
CBOT 5 yr	116.88	-0.15
CBOT 10 yr	118.58	-0.30
CBOT 30 yr	118.44	-0.53

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.140	0.160	-	-
1-Month	0.200	0.280	0.136	0.146
3-Month	0.220	0.400	0.147	0.157
6-Month	0.250	0.450	0.170	0.180
12-Month	0.600	1.000	0.286	0.296



CURRENCIES

	BID	ASK
Euro	1.3598	1.3600
Sterling	1.4951	1.4956
JP Yen	88.68	88.70
Swiss Franc	1.0759	1.0762
Can Dollar	1.0358	1.0362
Mexico	12.7384	12.7416

FED FUNDS NYFRSM - 10AM

Open	0.1400	1m	0.2188
High	0.1700	3m	0.2531
Low	0.0800		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1	04/04/2012	21	20.5	1.02
3-Year	1.375	09/01/2013	14.5	13	1.47
5-Year	2.875	09/02/2015	28.5	28	2.56
7-Year	5.125	18/10/2016	33.5	32.75	3.38
10-Year	-	-	-	-	-
30-Year	6.625	15/11/2030	35.5	35	4.92

ACTIVE FREDDIE MAC AGENCIES

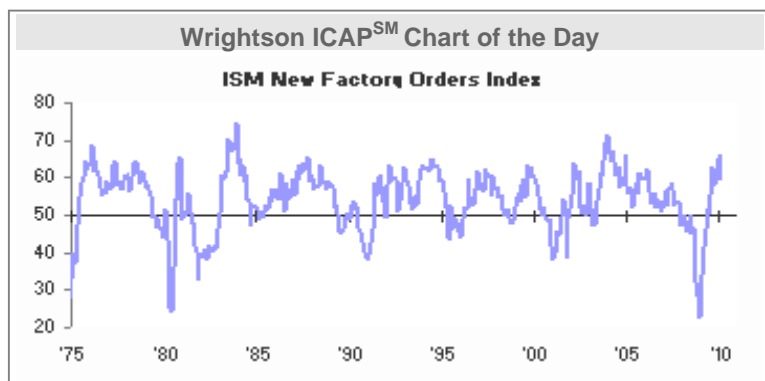
TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	15/12/2011	0	-2	<blank>
3-Year	1.75	22/02/2013	21.5	20.5	1.53
5-Year	2.625	20/11/2014	16.5	15	2.47
7-Year	5.25	15/09/2016	39.25	38.75	3.43
10-Year	3.75	27/03/2019	0	19	-
30-Year	6.25	15/07/2032	34.5	33.75	4.91

Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	5.0	105.2100	105.2300	2.516
FHLMC	5.0	105.1800	105.2000	2.554

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	5.5	105.1700	105.1900	2.945
FHLMC	5.5	105.2300	105.2500	2.818
GNMA	5.5	105.3000	106.0000	3.456



TODAY'S TOP NEWS

EU urges new Greek cuts, cabinet to meet on Weds

The European Union urged Greece to agree additional austerity measures within days to tackle a fiscal crisis that has shaken the euro zone and promised to help Athens overcome its debt problems.

EU Economic and Monetary Affairs Commissioner Olli Rehn said after a day of talks with Greek leaders that financial markets would be convinced the country will meet its deficit-reduction targets once they saw precise new measures.

Hours after Rehn's comments, the office of Greek Prime Minister George Papandreou announced a cabinet meeting for Wednesday to "take decisions about the economy".

No further details about the meeting were provided, but the announcement appeared to signal that Athens is poised to take new savings measures in the hopes of winning EU support, most likely in the form of guaranteed debt purchases.

His labor minister proposed a freeze on pensions this year as an extra measure to contain spending. Rehn said they also discussed several ways to reduce the public sector wage bill.

Separately, curbing short-selling on the cost of insuring Greek debt would not alone solve volatility, the chairman of Britain's Financial Services Authority said.

Obama proposes \$3,000 home energy rebates

President Barack Obama proposed rebates of up to \$3,000 to help homeowners pay for the cost of making their homes more energy efficient as part of a \$6 billion program to create jobs.

The announcement came as White House economic adviser Larry Summers predicted that winter blizzards were likely to distort U.S. February jobless figures.

The efficiency plan is intended to prompt Americans to invest in everything from insulation or new windows to overarching energy upgrades of their homes, creating construction and manufacturing jobs and boosting energy efficiency.

Consumers would be eligible for between \$1,000 and \$1,500 for simple home upgrades such as insulation, duct sealing, water heaters, air conditioning units, windows, roofing and doors.

Homeowners looking for more comprehensive energy retrofits would be eligible for a \$3,000 rebate if the efficiency measures lead to a 20 percent energy savings.

Separately, U.S. congressional Democrats prepared for a final push to pass healthcare reform without Republican support, even as President Barack Obama said he would explore adding more Republican ideas to his proposal.

Obama is expected to announce his plans on Wednesday for forging ahead with an overhaul of the \$2.5 trillion healthcare system.

New Basel rules could hit synthetic CDOs -Goldman

New bank capital rules could deal the final blow to any resurgence of deals in synthetic collateralised debt obligations as well as hurt the value of \$330 billion of existing triple-A tranches, Goldman Sachs said.

Proposed changes to Basel II rules, effective end-2010, would increase bank capital requirements by an estimated 11.5 percent overall and 223.7 percent in the trading book, according to a study by the Bank for International Settlements.

At the height of the financial crisis, fears of a market meltdown and defaults of investment-grade credits such as Lehman Brothers drove spreads of synthetic CDOs.

Spreads have since largely recovered, and a smattering of new deals have been done, but credit strategists at Goldman Sachs see the potential for new pain.

FDIC seen stepping up sales of failed bank assets

The U.S. Federal Deposit Insurance Corp is expected to offer \$3.8 billion of guaranteed securitizations backed by the residential mortgage assets of failed banks, market sources said.

The deals are expected to come in three separate transactions with Barclays Capital acting as sole manager for the sales, market sources said.

Its first \$1.81 billion two part transaction, is expected to price later this week. Two additional offerings, including a \$1.37 billion three-part sale and a \$668 million one-tranche deal, are seen pricing in the coming weeks, after investor road shows were held for all three, market sources said.

The asset sales are closely tied to the meltdown in the U.S. mortgage market and are seen as a positive step toward restoring investor confidence in the segment.

While the FDIC bonds are expected to also carry a government stamp, their origination via Wall Street suggests a stepping stone toward the kinds of private issuance seen crucial if U.S. housing is to wean itself from government support, analysts said.

In a move reminiscent of the Resolution Trust Corp, the government agency charged with insuring deposits and thrifts is employing securitization as a financial tool to help mop up the assets. The move has been anticipated by investors and dealers for months as the FDIC piles up loans from banks failing at an alarming rate.

Fed's Hoenig-Zero rate pledge invites speculation

A senior U.S. Federal Reserve official said that an extended period of ultra-low interest rates invites speculative behavior and is risky.

"When you have zero rates that go on indefinitely, you are inviting future problems," Kansas City Federal Reserve Bank President Thomas Hoenig said in an interview on CNBC.

"We know that zero is non-sustainable ... the market already knows that," Hoenig said.

Hoenig, who is voting this year on the Fed's policy-setting committee, is one of the more vocal anti-inflation hawks among policymakers. He dissented at the Fed's January meeting on the issue of maintaining a pledge to hold rates exceptionally low for an extended period, arguing the economy had improved sufficiently to drop the language.

The Kansas City Fed chief said the Fed should be ready to raise rates, even with unemployment above 9 percent.

"Removing and exiting these ... quantitative easing effects is not tight policy. It's removing very substantial easing policy," he said.

Fitch may cut Prudential Plc's ratings on AIG deal

Fitch Ratings said it may cut its ratings on Prudential Plc, citing the risks of its big acquisition of AIG's Asian subsidiary.

"The rating action centers on the agency's caution around the risks in executing such a large transaction and around Prudential's reliance on significant profitable growth of the businesses that would be acquired," Fitch said in a release.

Prudential has pulled in a range of banks to help it sell its \$21 billion rights issue, sources familiar with the matter said, as it seeks to broaden its shareholder base in Asia.

"Fitch expects that the new debt funding would lead to a reduction in Prudential's interest coverage, at least in the short term, which might add to the pressure on its ratings," the agency said. Fitch's long-term issuer default rating on Prudential Plc is AA-minus, its fourth-highest investment grade.



TODAY'S TOP NEWS

Abu Dhabi readies roadshow for new debt issues-IFR

Abu Dhabi is preparing a series of investor presentations for the Gulf emirate's upcoming issues of sovereign and quasi-sovereign debt though no timetable has been set yet, IFR Markets said. A figure of \$20 billion is being mentioned as a potential pipeline amount, IFR said.

Abu Dhabi is seen tapping debt markets this year to finance a range of infrastructure projects as well as ease issuance for government-linked firms in light of Dubai's debt woes.

Citibank, JP Morgan and Standard Chartered are working with Abu Dhabi's debt management office on the presentations but no dates or venues for the meetings have been confirmed, IFR said. Abu Dhabi is not under pressure to sell debt due to its vast oil wealth. The emirate last tapped markets in April 2009, selling \$3 billion worth of debt. Its entities issued another \$7 billion worth of debt in 2009, according to IFR data.

Euro zone inflation below consensus, seen subdued

Euro zone prices grew less than expected in February, a first estimate showed, pointing to low inflationary pressures and boosting expectations the ECB will only start raising interest rates in 2011.

The European Union's statistics office said consumer prices grew 0.9 percent year-on-year in February, slowing from a 1.0 percent gain in January. Economists polled by Reuters had on average expected a 1.0 percent year-on-year increase.

Euro zone core inflation is likely to have slowed down to new lows of 0.7-0.9 percent in February, economists said. Core inflation is likely to keep falling because of low capacity utilization in the economy. Eurostat said prices at factory gates rose 0.7 percent month-on-month in January and were down 1.0 percent year-on-year.

Separately, Switzerland's economic recovery gathered speed at the end of last year as growth broadened, reflecting a faster-than-expected rebound from the worst recession in more than three decades. The robust recovery supported views that the SNB will have to revise upwards its growth forecast for the economy at a meeting on March 11.

Bank of Canada holds rates, sees no early hike

The BoC held its key interest rate unchanged at the all-time low of 0.25 percent, as expected, and upheld its conditional commitment to keep rates at that level until the end of June.

While acknowledging stronger-than-expected economic growth and inflation, the bank also suggested it was not prepared to hike rates early because of slack in the economy, continuing currency strength and weak U.S. demand for Canadian exports. On the contrary, Australia's central bank raised its cash rate by 25 basis points to 4.0 percent and flagged further hikes ahead, saying a surprisingly strong recovery allowed it to move policy toward more normal settings.

Indeed, RBA Governor Glenn Stevens flatly stated that lending rates were still below average and today's move was just a step toward getting back there.

Interbank futures are fully priced for a move to 4.25 percent by July, and then in stages to 4.75 percent by December.

UK should aim for 3 pct deficit by 2014-Fitch

Britain is likely the AAA-rated nation most exposed to the financial crisis, and the British government needs to cut its budget deficit more sharply than is currently forecast by 2014, Fitch Ratings said.

Britain's credit profile has deteriorated after a very severe economic shock, and the country is highly exposed to the private sector reducing its debt burden, said Brian Coulton, managing director of European ratings for Fitch Ratings.

Markets fear political deadlock in Britain, with weekend polls showing the possibility of an inconclusive election that could hamper efforts to tackle a budget deficit forecast to exceed 12 percent of gross domestic product.

Meanwhile, Britain has a deficit problem but investors are starting to recognise that it has more options than countries like Greece to adjust its fiscal shortfall, the chief executive of PIMCO, the world's biggest bond fund, said.

Separately, British construction activity slowed slightly in February as the index fell to 48.5 in February from 48.6 in January.

NEXT UP

Range-bound, with ADP, ISM services on tap

U.S. Treasuries will likely trade within current ranges tomorrow, digesting fresh data on employment and the non-manufacturing sector, but waiting for U.S. payrolls data due on Friday.

On the other hand, talk of solutions to Greece's debt and fiscal issues weighs against Treasuries has damped the bid for safe-haven U.S. government debt.

The market must absorb February data on employment and non-manufacturing tomorrow, as well as the Federal Reserve's Beige Book, a narrative describing business conditions around the country.

The ADP National Employment report for February is expected to show that U.S. payrolls shed 20,000 jobs last month after losing 22,000 jobs in January, according to a Reuters poll.

February's ISM non-manufacturing index, due at 10 a.m. is expected to read 51.0, reflecting modest expansion, versus 50.5 in January.

Finally, the Fed's Beige Book, due at 2 p.m., is likely to reflect the observations contained in the Federal Open Market Committee's statement near the end of February: that the economy is strengthening while labor market deterioration abates.

Economists predict "slow burn" crisis for Greece

Greece will probably fail to rebuild its finances convincingly this year and its crisis will likely continue through 2010 in a "slow burn" scenario, a Reuters poll of economists showed.

Twenty-seven out of 47 respondents to the poll, conducted over the past two days, predicted this scenario, believing the Greek government would make only limited progress towards slashing its budget deficit.

In this scenario, financial markets would remain nervous about Greece's long-term fiscal and economic outlook, although the country would avoid having to default on its debt.

Respondents estimated a median 55 percent chance of Greece seeking a bailout from the European Union or IMF this year.

In the case of a bailout, most respondents said they would expect a package worth somewhere between 20 and 30 billion euros (\$27 billion to \$41 billion), with a median size of 25 billion euros.

Only 18 of 47 economists expected the country to meet its fiscal reform targets, which call for a 4 percentage point drop to 8.7 percent in its deficit-to-gross domestic product ratio this year, and further falls to below the EU ceiling of 3 percent in 2012.



DEEP DIVE Commentary and Analysis

Embrace reality, not fight speculation

By Jim Saft

Stock up on canned goods, the authorities appear to be opening a new front in the War Against Speculation; this time taking aim at the people who might profit from Greece and its European partners' woes.

Just days after the U.S. Securities and Exchange Commission voted new limits on short selling, Germany is investigating the credit default swap trading of speculators to try to prevent them from profiting from any bailout of Greece.

"It would be bad if it were to emerge after a rescue that the money had gone into the pockets of speculators," a source with knowledge of the efforts told Reuters.

"The result of the 'Greek tragedy' is that the political environment has become such that the Credit Default Swap (debt insurance) problem has come to the fore."

French Economy Minister Christine Lagarde on Sunday said that derivative trades on sovereign debt should be tightly regulated, limited or even banned.

That's right, apparently there is a big problem out there and it is that greedy speculators are betting that governments that look like they will have difficulties paying their debts might, well, have difficulties paying their debts.

Even worse, some are betting that since there is no tenable alternative to Greece being bailed out that it will be, well, bailed out.

I'm not sure if this is a war against speculation, against lese majeste or just against reality.

Fighting reality by punishing people who point it out, and, yes, may profit in the process, is a lot easier than addressing the fundamental underlying issues. Greece stands accused of fabricating its economic data, of borrowing too much and of using the proceeds not to fix the leaking roof but to expensively tile the kitchen. Greek wages and pensions went up 10.5 percent in 2009, for goodness' sake.

Further, the lack of an exit mechanism from the euro and the huge problems that a Greek default would pose for banks globally make a bailout a good bet.

These are not problems that can be solved by cracking down on speculation, any more than fraud at Enron could have been cured by a ban on short selling.

This is not an issue that will end with the euro zone. What derivative speculators on Greek debt are doing is little different at its heart than investors selling U.S. Treasuries or British gilts because they feel those countries' deficit situations are getting out of hand. These are simply bond market vigilantes in another form.

CAUTION, INTELLIGENCE AT WORK

Even better, countries are now so concerned with the dastardly deeds of the speculators they are apparently putting their intelligence services on the job.

Two Greek newspapers reported on Friday the country's EYP intelligence service was investigating speculative attacks on Greece in financial markets and had identified U.S. and British firms as aggressive sellers of Greek bonds. And the buyers, who were they? Probably best to ask the Germans, who since they are worried about profit from bailouts appear to be right on the case.

Similarly Spanish daily El Pais has reported that intelligence services in Spain, a leading candidate to be next in the line of highly indebted dominoes, were probing "speculative attacks" against the country.

I've got a budget saving hint for Greece and Spain: If reports that banks and hedge funds are betting on government debt

movements is typical of the value they are deriving from their intelligence service, well then, there are some attractive savings to be made.

Still, there are plenty of good reasons to regulate derivative markets. Credit default swaps are dangerous when they are used, as they were during the bubble, to create credit in the system without a similar growth in banking reserves, bypassing banking safety and soundness regulations. That is in essence what AIG did and was the reason that the shadow banking system drove the inflation in real estate and other assets.

Further, credit default swaps that are traded over the counter are a regulator's nightmare; it can never be clear whose house a given tree will fall on if it is hit by lightning, and the risks of highly interconnected banks can be amplified.

So, by all means, regulate credit default swaps and force them to be traded on exchanges.

It is always unpleasant to have our faults pointed out, and no doubt doubly enraging to pay for the privilege. The crime of lese majeste, which appears to be at the heart of the current concerns about sovereign derivatives, is not a valid basis for regulation.

On the broader issue, I'd suggest that rather than warring with speculation, euro zone nations would be better off negotiating a peace with reality.

(At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

Fears aside, US dollar best in a bad neighborhood

By Wanfeng Zhou

In just a few months, the market's perception of the U.S. dollar has turned 180 degrees.

Last year, the world was worried about a dollar crisis as the ballooning U.S. budget deficit sparked fears the greenback may lose its status as the international reserve currency.

In recent weeks, however, the dollar woes have been overshadowed by fiscal instability in Europe and problems elsewhere. Against a basket of currencies, the greenback has gained more than 9 percent since its lows in November.

Many analysts expect the dollar to stay firm against most currencies this year. While the U.S. deficit is still large, prospects for recovery appear better in the United States than in Europe and Japan. That, along with the uncertainty surrounding the euro zone, should boost the attractiveness of the greenback as an investment.

"The fiscal negatives are a lot less from the United States now than what they were a year ago," said Aroop Chatterjee, currency strategist at Barclays Capital in New York. "Sovereign risk is less of an issue for the dollar and more of an issue for the euro area."

Sentiment has turned to such an extent that the dollar was not hurt by recent data showing China sold a record amount of U.S. government debt in December -- news that would probably have pressured the currency in the past.

FAR FROM ROSY

To be sure, the U.S. fiscal deficit, which is projected this year to hit \$1.56 trillion, or 10.6 percent of gross domestic product, remains a negative influence. Many U.S. states, such as California, also face difficult budget decisions.

But economists say it's not the absolute level of U.S. debt that matters, but rather its relative position. With the euro zone, UK, and Japan all plagued by soaring government debt, the dollar's resilience reflects a realization that it's simply the best of a bad



DEEP DIVE Commentary and Analysis

bunch.

There's also scope for improvement on the U.S. fiscal front, especially if the recovery is stronger than anticipated, which would reduce further stimulus spending and boost tax revenue.

Nick Bennenbroek and Vassili Serebriakov, currency strategists at Wells Fargo, said data in the last 30 years do not show a "reliable statistical relationship" between budget deficits in the Group of 10 rich countries and their exchange rates.

During President Ronald Reagan's first term in the early 1980s, the rise in the budget deficit didn't hurt the dollar, which was supported by a tighter monetary policy and higher domestic interest rates. Conditions are different now, obviously - monetary policy is looser, rates are lower, and deficits are even larger.

THE TURN IN LIBOR

If the U.S. recovery is sustained, rates - both those set by the Federal Reserve and market rates - may continue to help the U.S. dollar in the coming months.

Yields on 10-year U.S. Treasury note were at 3.614 percent on Tuesday, higher than those of 10-year German government bonds at 3.11 percent.

In addition, key short-term U.S. dollar rates now match yen levels in Japan. Months of lower dollar rates helped fuel so-called carry trades, where investors sold dollars to fund purchases in other currencies and assets.

The three-month dollar-denominated London interbank offered rate was fixed at 0.2519 percent Tuesday, compared with the yen-denominated 3-month LIBOR rate of 0.2531 percent. If dollar rates continue to rise, the yen will take a greater share of the

funding trade that weakened the dollar in late 2009.

Since the fortunes of major world markets seem to have shifted for now, renewed economic weakness may still benefit the greenback, as a pullback leads to demand for U.S. currency.

"There's a little more uncertainty about the global recovery, and that's an environment where the dollar tends to do well," said Sophia Drossos, co-head of global currency strategy at Morgan Stanley in New York. "The U.S. cyclical data is outperforming other major economies like the U.K. and Europe."

Tony Crescenzi, market strategist and portfolio manager with PIMCO in Newport Beach, California, said with the euro in duress, global reserve managers will have no choice but to buy U.S. Treasuries because "there is no other bond market for the world to house its \$8 trillion of reserve assets."

While China sold some \$34 billion Treasuries in December, it added a net \$4.6 billion of long-dated Treasury bonds. Some analysts said this likely reflected falling safe-haven demand. Because of the crisis, China accumulated a long position of more than \$210 billion in short-term debt by May 2009, according to the U.S. Treasury; it now has just \$70.1 billion.

China's move to the long end of the curve could be a sign of confidence in the U.S. economy. India, Singapore and Korea also cut short-term Treasury holdings, Treasury data showed.

Purchases of U.S. debt by foreign countries like China have helped keep U.S. Treasury yields low over the past years. Some investors fear waning interest from overseas would lead to a spike in U.S. rates and cripple the economy, but that has not happened.

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