

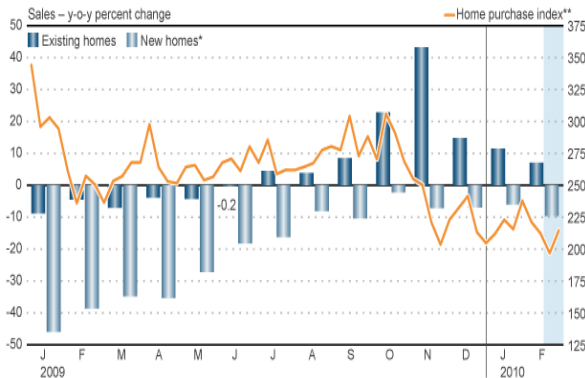
# INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Tuesday, March 23, 2010

## CHART OF THE DAY

### U.S. home sales



Sales of previously owned U.S. homes fell less than expected in February that underscored the fragile nature of the housing market's recovery.

## TODAY'S TOP NEWS

- U.S. home sales dip, credit-related surge eyed
- Germany sets tough terms for EU help for Greece
- Obama signs historic healthcare overhaul into law
- Geithner: Keep public role in housing finance
- Fed's Plosser: better rules needed to manage risk
- Average U.S. 2-year auction kicks off week's supply
- 10-yr swap yields below Treasuries on heavy demand
- IRS issues guidance on U.S. stimulus tax credit bonds

## ECON WATCH

FOR WEDNESDAY MARCH 24

ET	Indicators	Unit	Reuters	Prior
03:58 FR	Markit/CDAF Ser PMI	ind	54.8	54.6
04:28 DE	Markit/BME Mfg PMI	ind	56.8	57.1
04:28 DE	Markit Service PMI	ind	52.2	51.7
04:30 IT	Consumer confidence	ind	108.0	107.7
04:58 EZ	Markit Mfg Flash PMI	ind	54.0	54.2
04:58 EZ	Markit Serv Flash PMI	ind	52.0	51.8
04:58 EZ	Markit Comp Flash PMI	ind	53.8	53.7
05:00 DE	Ifo business climate	ind	95.8	95.2
06:00 EZ	Industrial new orders mm	%	1.9	0.8
06:00 EZ	Industrial new orders mm	%	14.2	9.5
08:30 US	Durable goods orders	%	0.7	2.6
08:30 US	Durable gds ex-trans	%	0.6	-1.0
08:30 US	Durable gds ex-def	%	1.1	1.1
08:30 US	Non-def cap ex-aircrf	%	2.3	-4.1
10:00 US	New home sales-units	mln	0.32	0.309
- US	Build permits R num	mln	-	0.612

## MARKETS TODAY

**TODAY'S TOP STORY:** Sales of previously owned U.S. homes fell for a third straight month in February and the supply of unsold houses on the market surged, showing the housing market was struggling to find its feet. [For more please click here](#)

**TREASURIES:** U.S. Treasuries prices were little changed as some disappointment in the results of a two-year note auction was offset by safe-haven bidding sparked by resurging concerns over Greece's debt problems.

- Traders had expected the yield on the 2-yr notes due March 2012 to clear at 0.996 pct, below the 1.000 pct high yield at the auction.
- 30-yr bonds prices fell 18/32 to yield 4.61 pct.
- 10-yr Treasury notes were down 8/32 to yield 3.69 pct
- 2-10's part of the yield curve steepened by 2 bps to 271 bps.

**FOREX:** The euro slipped against the dollar as investors worried that euro zone policy makers are unlikely to provide a rescue package for Greece at a summit later this week.

- Euro shed 0.45 pct to \$1.3499, after trading as low as \$1.3477 earlier.
- The euro fell 0.49 pct to 1.4275 Swiss francs. It fell to a record low against the Swiss franc at 1.4271 francs.
- Dollar rose 0.03 pct to 90.37 yen, while the euro fell 0.15 pct to 122 yen.

**CORPORATES:** U.S. corporate bond spreads were unchanged to tighter as strong demand for more than \$11 billion in new issuance gave the market a firm tone.

- Wells Fargo launched \$1.25 bln of five-yr notes.
- Thomson Reuters Corp launched a \$500 mln 30-year senior unsecured debt sale.
- Philip Morris International launched a \$1 bln 10-yr note sale.
- GMAC Inc added \$400 mln to existing senior unsecured notes.

**STOCKS:** U.S. stocks rose, lifting the Dow and the S&P 500 to 18-month closing highs, as a report signaling further signs of stabilization in housing fueled investor appetite for riskier assets.

- Dow rose 0.95 pct to 10,888.83, S&P was up 0.72 pct to 1,174.17 and Nasdaq gained 0.83 pct to 2,415.24.
- Shares of Caterpillar Inc added 4.10 pct to \$62.41.
- The Dow Jones U.S. home construction index fell 0.47 pct, while the KB Home dropped 1.66 pct to \$17.15.
- Philadelphia semiconductor index was up 2.26 pct, Intel Corp gained 1.94 pct to \$22.67. Cigna Corp fell 0.91 pct to \$36.94.
- Google shares were down 1.52 pct to \$549.0.
- S&P technology index rose 0.94 pct, S&P financial index rose 0.77 pct.

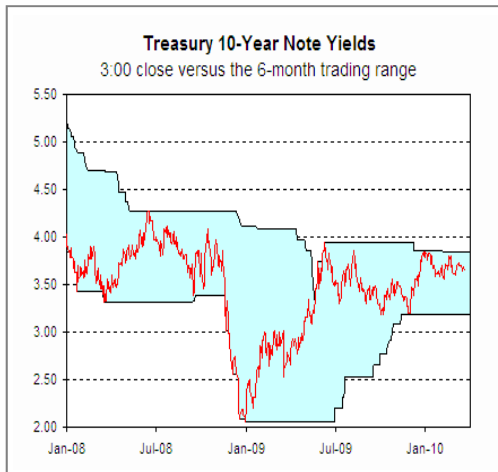
**C & E:** Oil prices steadied below \$82 a barrel as a stronger dollar and lackluster equities markets dragged commodity prices and offset encouraging U.S. housing data that fed economic optimism.

- U.S. oil prices rose 0.37 pct to \$81.9 per barrel.
- Gold gained 0.03 pct to \$1,104.95 per ounce.
- Reuters-Jefferies index shed 0.21 pct to 271.71.

- [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	0.115	0.085	0.117	-0.018
3-Mo Bill	0.135	0.125	0.137	-0.007
6-Mo Bill	0.225	0.220	0.228	-0.007
1-Year	0.378	0.370	0.384	-0.010
2-Year	99.789	99.820	0.986	-0.016
3-Year	99.531	99.563	1.537	-0.016
5-Year	99.805	99.852	2.417	-0.012
7-Year	99.313	99.359	3.111	-0.008
10-Year	99.516	99.578	3.684	-0.172
30-Year	100.406	100.469	4.600	-0.406

**EQUITIES**

	INDEX	CHANGE
DJIA	10847.34	61.60
NASDAQ	2405.60	10.20
S&P 500	1169.60	3.79

**OIL**

	PRICE	CHANGE
NYMEX	81.9	0.3
BRENT	80.7	0.1

**EURODOLLAR FUTURES**

	CLOSE	CHANGE
Apr-10	99.685	0.015
Jun-10	99.620	0.015
Sep-10	99.435	0.015
Dec-10	99.155	0.015

**REPURCHASE AGREEMENTS**

G/C		MORTGAGE REPOS	
O/N	0.260	O/N	0.250
2-Week	0.240	2-Week	0.250
1-Month	0.250	1-Month	0.270
3-Month	0.280	3-Month	0.300
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX	
O/N	0.250	10:00 AM	0.160
2-Week	0.260	3:00 PM	0.185
1-Month	0.260		
3-Month	0.290		

**IR SWAPS <19901>**

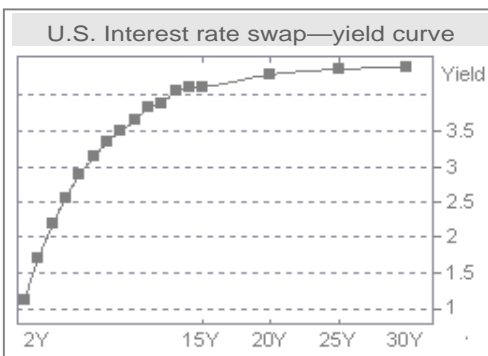
	SPREAD		RATE	
2-Year	15.00	19.00	1.12	1.15
3-Year	17.75	21.75	1.71	1.72
5-Year	16.75	20.75	2.58	2.58
7-Year	4.25	8.25	3.15	3.14
10-Year	-4.50	-0.50	3.63	3.62
30-Year	-22.50	-18.50	4.37	4.35

**FUTURES**

	PRICE	CHANGE
CBOT 5 yr	116.41	-0.02
CBOT 10 yr	118.45	-0.31
CBOT 30 yr	119.19	-0.25

**EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)**

	BID	ASK	BID	ASK
O/N	0.200	0.250	-	-
1-Month	0.220	0.280	0.186	0.196
3-Month	0.240	0.400	0.196	0.206
6-Month	0.350	0.450	0.232	0.242
12-Month	0.700	1.050	0.391	0.401



**CURRENCIES**

	BID	ASK
Euro	1.3488	1.3490
Sterling	1.5032	1.5036
JP Yen	90.37	90.40
Swiss Franc	1.0577	1.0580
Can Dollar	1.0177	1.0182
Mexico	12.5085	12.5146

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

Open	0.1700	1m	0.2300
High	0.2000	3m	0.2781
Low	0.1300		

**ACTIVE FANNIE MAE AGENCIES**

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1	12/04/2012	13 12	1.09
3-Year	1.625	15/04/2013	19.5 0	1.72
5-Year	2.875	09/02/2015	24.5 22.5	2.66
7-Year	5.125	18/10/2016	22 0	3.33
10-Year	-	-	- -	-
30-Year	6.625	15/11/2030	39.5 0	4.99

**ACTIVE FREDDIE MAC AGENCIES**

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1.125	15/12/2011	0 -5	-
3-Year	1.75	07/05/2013	22 0	1.74
5-Year	2.625	20/11/2014	15 12	2.57
7-Year	5.25	15/09/2016	18 0	3.29
10-Year	3.75	27/03/2019	23.5 0	3.9
30-Year	6.25	15/07/2032	39.5 0	4.99

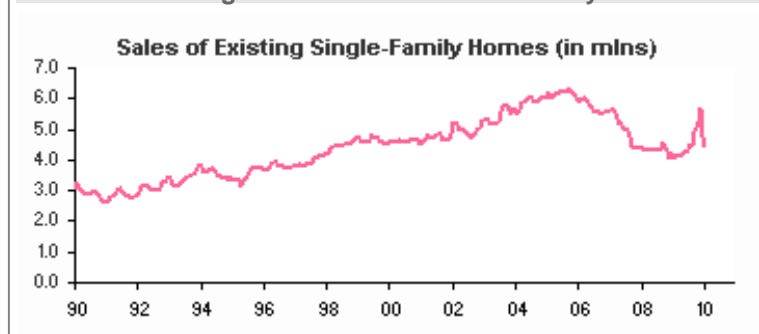
**Active MBS 15YR**

	CPN	BID	ASK	YIELD
FNMA	5.0	105.2760	105.2820	2.929
FHLMC	5.0	105.2760	105.2820	2.785

**Active MBS 30YR**

	CPN	BID	ASK	YIELD
FNMA	5.5	105.2660	105.2720	2.988
FHLMC	5.5	106.0600	106.0700	2.846
GNMA	5.5	106.0860	106.0920	2.802

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



## TODAY'S TOP NEWS

**U.S. home sales dip, credit-related surge eyed**

Sales of previously owned U.S. homes fell for a third straight month in February and the supply of unsold houses on the market surged, showing the housing market was struggling to find its feet.

Existing home sales dipped 0.6 percent month-over-month to an annual rate of 5.02 million units, the National Association of Realtors said. The drop last month was a touch less than market expectations for a fall to 5.0 million units.

According to analysts, home purchases were pushed forward to take advantage of the tax credit that had been originally scheduled to end last November. Some doubted a last minute surge in sales would materialize as buyers try to beat the April deadline to sign contracts and close them by June. With sales dropping again last month, the inventory of existing homes for sale jumped 9.5 percent to 3.59 million units. That represented 8.6 months' worth of supply -- the highest since August.

The rise in the supply of homes on the market pushed the national median home price down 1.8 percent from February last year to \$165,100.

A separate report from the U.S. Federal Housing Finance Agency showed house prices fell 0.6 percent month-on-month in January. They fell 3.3 percent in the 12 months to January.

**Obama signs historic healthcare overhaul into law**

President Barack Obama sealed a hard-fought victory by signing into law a landmark healthcare reform measure that will help shape his legacy and the Democrats' chances of holding power in the U.S. Congress.

But 13 of the 50 U.S. states went to federal court and filed a lawsuit challenging the measure just minutes after Obama signed it into law.

The states argue that Congress lacks authority under the Constitution to regulate interstate commerce to require people to buy health insurance, as the new law does. The White House has said it does not expect the suit to be successful.

The new law is designed to revamp the \$2.5 trillion U.S. health-care industry. The law extends insurance coverage to 32 million Americans, expands the government health plan for the poor, imposes new taxes on the wealthy and bars insurance company practices like refusing cover to people with pre-existing medical conditions. Republicans have vowed to fight those changes, but Democratic leaders say they are confident they have the votes to push them through.

**Fed's Plosser: better rules needed to manage risk**

Better regulation is needed to dissuade financial market players from taking excessive risks after the "too big to fail problem" undermined discipline, a senior U.S. Federal Reserve official said.

Philadelphia Federal Reserve Bank President Charles Plosser said there were ways to discipline the market -- some within the market itself -- to prevent excessive risk taking.

His comments followed statements from Federal Reserve Chairman Ben Bernanke, who said over the weekend that regulators should be significantly tougher on large and complex financial firms. "The too big to fail problem has essentially removed much of that market discipline," Plosser told an economic conference in Prague. "We have to have ways of disciplining the actors in the marketplace so that they don't take excessive risks, and in many cases the market can do that and do that quite effectively. But when we protect creditors, when we protect people from failure, we encourage them to take risks."

**Germany sets tough terms for EU help for Greece**

Germany signalled for the first time that it may accept European financial aid for Greece as a last resort, but only if the IMF helps first and euro zone partners accept tougher budget discipline rules.

A senior German official spelled out Berlin's conditions for any aid mechanism ahead of an EU summit starting on Thursday:

Greece would have to be unable to access credit markets; the IMF would have to contribute to any rescue; EU states would have to agree to negotiate "additional instruments" to enforce budget discipline, beyond existing rules that failed to prevent Athens running up huge debts and deficits that have shaken the euro zone.

ECB President Jean-Claude Trichet and Eurogroup chairman Jean-Claude Juncker have said involving the Washington-based lender would send a damaging message that the euro zone was incapable of handling its own problems.

Credit ratings agency Fitch said it doubted EU leaders would offer Greece aid at the summit but failure to reach a deal would not trigger a downgrade as long as the IMF option was open.

Lending money to Greece at 'normal' interest rates would not be a bailout, ECB policymaker Vitor Constancio said.

**Geithner: Keep public role in housing finance**

The government should continue to play a role in any new system of housing finance Congress develops, Treasury Secretary Timothy Geithner told lawmakers as they began to debate an overhaul of the way Americans buy their homes.

Despite the need for some government role, mortgage finance giants Fannie Mae and Freddie Mac should not be fully nationalized, the Treasury chief said.

Geithner said the central role the housing sector plays in the U.S. economy and its vulnerability to financial shocks justified a degree of government backing.

The hearing marks a first step in what is expected to be a long debate on how best to build a system to ensure a liquid source of home mortgage finance.

The public bailout was supposed to buy time for policymakers to figure out what to do with the two entities. Fannie Mae and Freddie Mac own or guarantee about half of all U.S. mortgages and are critical to the housing sector and the entire U.S. economy.

In the year and a half since the firms were placed under government control, the Obama administration has been relatively mum on its plans for the future.

Geithner laid out broad principles for reform and said the administration would eventually propose a comprehensive plan to overhaul the housing finance system.

**Average U.S. 2-year auction kicks off week's supply**

Investors offered a casual reception to fresh two-year U.S. Treasury debt, kicking off this week's \$118 billion in longer-dated supply.

The bid-to-cover ratio was 3.00, compared with 3.3 at the February auction.

"The auction was a little weak," observed John Spinello, chief fixed-income technical strategist at Jefferies & Co. in New York. In the when-issued market, traders had expected the yield on the two-year notes due March 2012 to clear at 0.996 percent, below the 1.000 percent high yield at the auction.

In the open market, the two-year Treasuries were yielding 0.953 percent shortly before the Treasury announced the two-year auction results.



## TODAY'S TOP NEWS

**10-yr swap yields below Treasuries on heavy demand**

The cost to exchange fixed-rate dollars with floating-rate ones in the interest rate swap market fell amid demand from supply hedging and keen interest in long-dated investments.

The yield on U.S. 10-year swap contracts fell below that on 10-year U.S. Treasuries for the first time in 14 months.

The disappearance of a risk premium on 10-year swaps over Treasuries spurred chatter that traders are worried about the long-term credit-worthiness of the U.S. government, which is no better than that of a top-rated U.S. bank.

A majority of analysts, however, do not share this dire view of U.S. sovereign credit, despite worries over the burgeoning federal deficit and debt agencies' caution over the massive borrowing on United States' coveted triple-A rating.

Most analysts attributed the spread tightening to heavy demand for long-dated, fixed-rate dollars due to low inflation and the Federal Reserve's pledge to keep interest rates near zero to support the economic recovery.

The spread on the 10-year swap over Treasuries was last quoted at minus 1.75 basis points, a record intraday discount.

**IRS issues guidance on U.S. stimulus tax credit bonds**

The Internal Revenue Service released guidance on selling and trading tax credits attached to special stimulus bonds, answering questions about how the government will track who owns the credits. The municipal bond market has awaited guidance on this feature of "tax-credit" bonds included in the \$863 billion economic stimulus plan for more than a year. Since then, the U.S. Congress has passed a law changing the bonds' structure, which could render the guidance irrelevant for many issuers.

"Tax-credit bonds" offer a credit against federal income tax in lieu of interest payments.

The federal government is allowing the credits to be separated, or stripped, from the bonds and resold. The market for tax-credit bonds has existed for some years but has generated limited interest from buyers. Under the guidance the credits will be limited by taxpayers' income tax liabilities and if they exceed that limit then the credits will be carried over to the following year.

**China trade blamed for 2.4 mln lost U.S. jobs-report**

Unfair Chinese trade and currency practices caused the loss of as many as 2.4 million U.S. jobs between 2001 and 2008, according to a study released. The report by the left-leaning Economic Policy Institute said China's "currency manipulation" was a major cause of the United States' trade deficit with China, though it said other Chinese practices contributed to the deficit.

The U.S. trade deficit with China grew from \$83 billion in 2001 to a record \$268 billion in 2008 before falling to \$226 billion in 2009 alongside a collapse in world trade.

The report estimated that 2.4 million U.S. jobs have been lost or displaced in the United States as a result of the burgeoning trade deficit since China joined the World Trade Organization in late 2001. The lawmakers believe China deliberately undervalues its currency by up to 40 percent, giving Chinese competitors an unfair price advantage that has led to U.S. job losses.

Separately, China will probably run a trade deficit of more than \$8 billion in March, state media said, citing Premier Wen Jiabao.

**Japan govt to face big fund shortage in 2011/12-Nikkei**

Japan's government may need to issue more bonds or drop some spending plans as it faces a shortage of up to 7 trillion yen (\$78 billion) in funds in the year to March 2012, the Nikkei newspaper reported.

An increase in bond issuance would raise the spectre of a cut in Japan's sovereign ratings as the national debt is nearing 200 percent of its gross domestic product, analysts say.

It may need to issue even more in the following year from April 2011 as it faces a 6 trillion yen to 7 trillion yen fund shortage if it is to meet the party's election pledges while tax revenues shrink, the Nikkei said without citing sources.

The government would have to cut spending, raise taxes or issue more new bonds to cover the shortfall, the paper said.

The Nikkei said tax revenues were likely to fall to 42.6 trillion in 2011/12 from an expected 48 trillion in the year from April 1, a forecast some economists said might be too gloomy and probably reflected a desire by finance ministry mandarins to pressure politicians to do more on fiscal reform.

## NEXT UP

**Tax credit hangover to weigh on U.S. Feb home sales**

The median forecast for new home sales is for a small rise to an annual rate of 320,000 units from 309,000 in January. Forecasts ranged from 290,000 to 340,000 units. Continued payback from the initial tax credit for first-time buyers probably weighed on U.S. home sales in February, which could heighten fears of a housing market relapse. Home sales have trended weaker in recent months as the boost from the initial \$8,000 tax credit faded. Despite the extension and expansion of the popular tax credit, sales have remained depressed.

New home sales are expected to edge up from January's record low levels. The declining new home sales, combined with weakness in construction, has caused economists at Moody's Economy.com to scale back estimates of growth in residential investment this year to 3 percent from 6 percent.

The weakness in sales comes against the backdrop of the end next week of the Federal Reserve's purchases of mortgage-related securities, which had pushed down home loan rates. The slowdown in sales has raised the number of homes on the market and dealt a setback to prices, which had started to stabilize.

**U.S. crude oil stocks seen up as imports rise**

U.S. crude oil stockpiles rose last week as imports edged up and refinery demand was flat, an expanded Reuters poll of industry analysts showed ahead of weekly inventory reports.

On average, crude supplies were forecast up 1.5 million barrels, the poll of 16 industry analysts showed.

Gasoline stocks were forecast down 1.3 million barrels, with demand seen rising with refinery production flat as refiners try to work off winter-grade supply overhang before getting into the start of the driving season, analysts said.

Distillate stocks, which include heating oil and diesel, were expected down 1.0 million barrels, hewing close to seasonal tendencies, according to the analysts.

The refinery utilization rate was forecast unchanged at 80.6 percent of capacity, the poll showed.

In the comparable week a year ago, refinery utilization edged down 0.1 percentage point to 82 percent of capacity.

The views on refinery utilization were mixed, with six expecting the rate to have risen, five forecasting a decline, and three projecting no change. Two of the analysts did not provide any utilization estimate.



## DEEP DIVE Commentary and Analysis

**Battling for the soul of the euro**

By Neal Kimberley

The continuing uncertainty over Greece's finances can no longer disguise the fact that the real argument is over the future character and direction of the euro.

While the market currently chooses to sell euros on Greek woes, it may well be that, ultimately, what is bad for Athens may be seen as good for the single currency.

Although a German government spokesman said on Monday that Greek Prime Minister George Papandreou had made clear to German Chancellor Angela Merkel that Greece does not need aid, the European Union's (EU) failure so far to provide a concrete support mechanism points to internal disagreements and undermines the value of the euro.

On Monday EUR/USD fell to \$1.3461 and the Greek/German 10-year government bond yield spread widened to 344 basis points on reports that Athens might even turn to the International Monetary Fund (IMF) in the absence of any EU aid mechanism.

But perhaps this is Germany's preferred solution. Perhaps Germany, recognizing the antipathy of the German populace to funding a bail out, wants to avoid the situation where euro zone members, who fail to adhere to the spirit -- as well as the letter -- of the Stability and Growth Pact get a hand out.

German Foreign Minister Guido Westerwelle does not want any German or EU money put forward as financial aid to Greece as he says it would alleviate the pressure on Athens to put its own house in order.

Perhaps at heart, the constraints of the German constitution preclude Merkel signing up to an aid package that could be challenged and possibly overturned at Germany's Constitutional Court in Karlsruhe.

Moreover, bringing Greece to book could result in a perception that the euro zone does not brook backsliding. Such a view would serve to underpin the notion that the euro is a hard currency, more akin to the deutschemark than other constituent currencies.

Indeed when an unidentified senior Greek official said on Thursday that Greece might seek financial aid from the IMF as it is increasingly pessimistic about the chances of support from the EU, a German government spokesman stated that Berlin does not rule out such an option.

Yet French Economy Minister Christine Lagarde is on record as saying Greece's fiscal problems must be solved within the euro zone rather than with the IMF.

The alternative suggestion that the EU might establish a European Monetary Fund as some sort of "emergency facility" might founder on Merkel's belief that such a move would need changes to the Lisbon Treaty.

Treaty changes would require the unanimous agreement of the broader 27-nation EU, including ratification by parliamentary vote or referendum in all member states.

No one in the EU wants to go down that path again.

The underlying question of how to establish governance amongst a currency union of sovereign states each with an independent fiscal policy remains unanswered. But how Greece's problems are resolved will point the way.

The splits within the EU are clear.

Italian Prime Minister Silvio Berlusconi sees the EU as a body whose duty it is to help a member state in trouble. "I think that if within the European Union there is no willingness to help a country which has the euro, and is in the middle of a crisis, then the European Union has no reason to exist.

European Commission President Jose Manuel Barroso has urged EU member states to agree a standby aid package for Greece at a Brussels summit scheduled for March 25-26.

Merkel disagrees: "As long as Greece does not need help, this issue does not have to be at the forefront of our talks. Aid will not be on the agenda at the meeting on Thursday because Greece says itself it does not need help right now".

The bottom line is Greece's problems have become an argument over the vision for the euro. And as the euro is a political construction, it will be EU politicians who craft the solution.

At the moment, the currency market sells euros when concerns over Greece rise, and buys euros when they abate.

But if the solution to Greece's problems necessitates an EU aid package that leaves the impression that those who flout the rules of the club will be bailed out by the others, then currency traders may end up having a lower opinion of the euro.

If the EU, presumably compelled by Germany, hangs tough and Greece is driven to accept IMF aid, the market may well conclude that the integrity of the euro has been reinforced.

This is no longer about Greece. This is about the future of the single currency and how it is perceived. And the paradox is that the euro may yet rise if Greece is actually pushed into the arms of the IMF.

-- Neal Kimberley is an FX market analysts for Reuters. The opinions expressed are his own --

**HMOs may hike premiums, slash jobs under reform**

By Lewis Krauskopf

Health insurers may turn to steeper premium increases, job cuts and dealmaking to maintain profits in the wake of a landmark U.S. health overhaul that imposes new regulations and costs on the industry.

The U.S. House of Representatives approved the reform legislation late on Sunday, climaxing a year of uncertainty over the overhaul that cast a long shadow over the health insurance industry's future.

The overhaul faces expected approval in the Senate later this week while a legal threat looms from at least 11 states.

Should the changes become law, they create myriad pressures -- some almost immediately -- on the industry's ability to maintain its profitability.

While many of the provisions and fees based on market share do not kick in until 2014, some analysts expect insurers will act soon to shore up margins.

"All of this is going to cause the cost of healthcare insurance premiums to skyrocket massively," Collins Stewart analyst Brian Wright said.

"These companies can't run at a loss, so while you can eat some margin at the end of the day you have to massively raise prices. Massively," Wright said. "California will be begging for only 39 percent rate increases."

Democrats in recent weeks had seized on the insurers' rate hikes to generate momentum for health reform, including holding a Congressional hearing on WellPoint's increases of as high as 39 percent.

The Morgan Stanley Healthcare Payor index of insurers rose 1.3 percent on Monday, although large insurers WellPoint and UnitedHealth Group <UNH.N> traded lower.

**MORE REGULATION FOR INSURERS**

The legislation expands coverage to 32 million Americans, adding a wealth of new potential customers for the insurers.

But because health plans will no longer be able to exclude people from coverage because of pre-existing illnesses, analysts fear the insurers will be burdened by greater medical costs that hurt profits.

Other regulations include mandating how much premium reve-



## DEEP DIVE Commentary and Analysis

nue the plans can spend on medical costs -- another potential squeeze to their profit margins.

"Now they're much more heavily regulated than they ever were before," said Tim Nelson, a healthcare analyst with First American Funds.

The health insurers also face significant cuts to rates for Medicare Advantage plans for the elderly, a growth area for companies such as Humana and UnitedHealth.

To adjust, analysts say health insurers will look hard at passing on costs through sharp premium rate increases, but that may hold political dangers.

Even though Democrats do not need to harp on premiums to pass the legislation any more, the political climate may stay hostile against hefty increases.

"If they do raise their premiums as a way to combat against this ... it might not be as viable as it has been in the past," Edward Jones analyst Steve Shubitz said. "There's going to be more scrutiny."

With rate increases potentially more challenging to pull off, health insurers may try to slash administrative costs.

Health insurers across the board have already announced job

cuts over the past two years to adjust for fewer members stemming from the weak economy.

But more job reductions could be on the way, said Sanford Bernstein analyst Ana Gupte. The insurers also may seek to renegotiate their contracts with brokers and take other actions to operate more efficiently, she said.

"I think they will make a much bigger push to reduce some of their administrative costs," Gupte said.

Health insurers also may take a harder line in negotiating rates with hospitals, Gupte said.

The approval of reform also could clear the way for more mergers among health insurers, as they seek greater leverage in negotiating rates with providers.

With the legislation expanding the Medicaid program for the poor, companies that specialize in Medicaid plans such as Amerigroup or Centene could become desirable targets.

"I think there will be more consolidation in managed care, definitely," said Maria Mendelsberg, a principal at Cambiar Investors. "You couldn't have any deals happen until this got resolved."

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(Compiled by Anil Kumar, Pronita Naidu and Mowna Ravikumar in Bangalore)

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