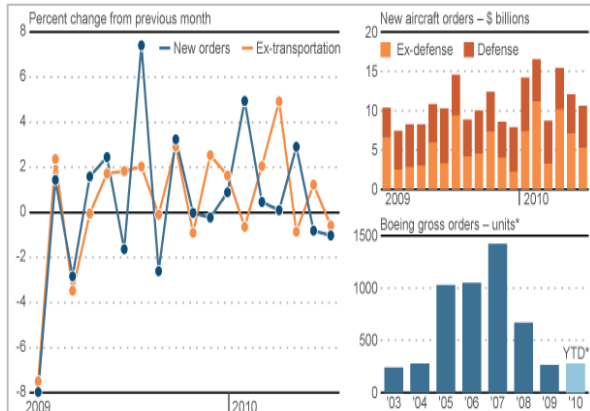


## CHART OF THE DAY

### U.S. durable goods orders fall due to aircraft



New orders in June were expected to rise on Boeing's increases civilian aircraft orders; however, total non-defense aircraft orders were down 25.6 percent.

## TODAY'S TOP NEWS

- U.S. durable goods orders fall, but business spending up
- Cutting U.S. deficit a matter of timing - Orszag
- SEC should permanently change ABS rule
- U.S. 5-year debt auction draws strong demand
- U.S. mortgage brokers to be fingerprinted, registered
- ECB lays out new sliding scale of collateral haircuts
- Goldman, Citi in \$788.5 mln CMBS deal-term sheet
- Spain central govt H1 deficit down 24.7 pct y/y

## ECON WATCH

FOR THURSDAY JULY 29

ET	Indicators	Unit	Reuters	Prior
2:00	GB Nationwide mm	%	-0.2	0.1
4:00	DE Unemployment Rate sa	%	7.6	7.7
4:00	DE Unemployment Chng sa	k	-20	-21
4:30	GB BoE Cons Credit, GBP	bln	0.3	0.331
4:30	GB BoE Mortgage Approvals	k	49.0	49.82
4:30	GB BoE Mortgage Lending	bln	1.0	1.184
5:00	EZ Business Climate	ind	0.39	0.37
5:00	EZ Economic Sentiment	ind	99.0	98.7
5:00	EZ Industrial Sentiment	ind	-5	-6
5:00	EZ Services Sentiment	ind	5	4
5:00	EZ Consumer Sentiment	ind	-14	-17
8:30	US Initial Claims	k	459	464
8:30	US Continuing Claims	mln	4.55	4.487
8:30	CA Producer prices mm	%	0.0	0.3
8:30	CA Raw materials mm	%	1.0	-7.2
-	GB GfK Cons Confidence	ind	-20	-19

## MARKETS TODAY

**TODAY'S TOP STORY:** New orders for U.S. manufactured goods like cars and planes fell unexpectedly for a second straight month in June, posting the largest drop since August in a sign economic recovery cooled in the second quarter. **For more please click here**

**TREASURIES:** Middle-maturity U.S. Treasury debt prices gained, while the 30-year bond edged higher, following a strongly bid auction of five-year notes.

- The 5-yr sale attracted bids worth 3.06 times the amount on offer, well above the historical average of 2.34 times and the strongest in nearly 4 years.
- 30-year bonds gained 8/32 to yield 4.07 pct.
- 10-year notes rose 15/32 yielding 3.00 pct from 3.05 pct.

**FOREX:** The U.S. dollar rose against the euro but fell against the yen as a weaker-than-expected reading on new orders for U.S. durable goods added to fears about the economic outlook of the world's largest economy.

- Euro fell 0.13 pct to \$1.2984, with the session low at \$1.2968.
- Against the yen, dollar shed 0.51 pct to 87.44 yen and euro lost 0.64 pct to 113.54 yen.
- Sterling slid 0.06 pct to \$1.5585 and dollar index fell 0.04 pct.
- Australian dollar fell 0.93 pct to \$0.8926.

**CORPORATES:** U.S. corporate bond spreads widened as weaker stocks took a toll on sentiment and bond investors took profits following more than three weeks of spread tightening.

- U.S. corporate bond spreads widened 3 bps to 105 bps.
- Ford Motor finance arm surfaced in the high-yield market with a \$1.25 billion bond sale, pushing this week's high-yield bond issuance total to about \$4.5 billion. Ford Motor Credit sold \$1.25 bln of 7-yr notes. The 6.625 pct notes were priced at 98.485 to yield 6.90 pct or 449 bps.
- UBS AG launched \$2.5 bln of 5-yr notes while McDonald's sold \$750 mln of notes in two parts.

**STOCKS:** U.S. stocks ended lower after weak durable-goods figures and a downbeat assesment of the economy from the Fed's Beige Book kept the benchmark S&P 500 trapped below its 200-day moving average.

- Dow shed 0.37 pct to 10,498.41, S&P was down 0.69 pct at 1,106.11 and Nasdaq slipped 1.04 pct to 2,264.56.
- Boeing's shares fell 1.89 pct to \$67.32, General Dynamics rose 0.06 pct to \$61.81, while ConocoPhillips was up 0.02 pct at \$54.45.
- Visa fell 1.87 pct to \$75.18, Meritage dipped 6.07 pct to \$16.88, and the PHLX Housing Index fell 3.02 pct.
- S&P technology index fell 0.95 pct, KBW bank index fell 1.34 pct.

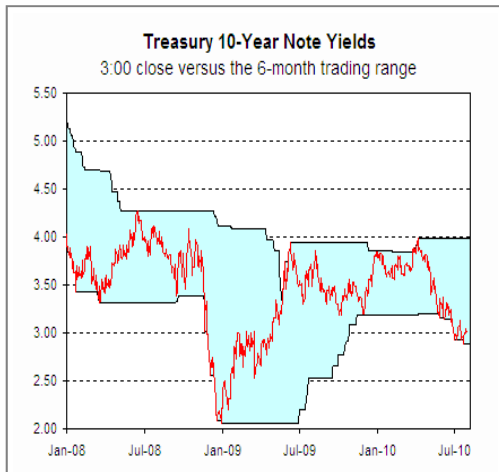
**C & E:** U.S. crude oil futures fell a second straight day, slipping on government oil inventory data showing a large crude oil stocks build last week as imports surged.

- U.S. crude oil fell 0.94 pct to \$76.77 per barrel.
- Gold rose 0.27 pct to \$1,162.8 an ounce.
- Reuters-Jefferies index gained 0.64 pct to 266.16.

- 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	0.165	0.13	0.167	-0.004
3-Mo Bill	0.150	0.140	0.152	-0.004
6-Mo Bill	0.200	0.195	0.203	-0.004
1-Year	0.300	0.275	0.305	-0.008
2-Year	100.000	100.031	0.626	0.117
3-Year	100.156	100.195	0.947	0.215
5-Year	100.773	100.820	1.711	0.406
7-Year	100.547	100.594	2.414	0.477
10-Year	104.172	104.234	3.005	0.414
30-Year	105.078	105.141	4.079	0.109

EQUITIES

	INDEX	CHANGE
DJIA	10472.38	-65.08
NASDAQ	2259.47	-28.88
S&P 500	1103.78	-9.99

OIL

	PRICE	CHANGE
NYMEX	76.8	-0.7
BRENT	75.8	-0.3

EURODOLLAR FUTURES

	CLOSE	CHANGE
Aug-10	99.565	0.028
Sep-10	99.575	0.000
Dec-10	99.525	0.000
Mar-11	99.445	0.000

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.260	O/N	0.280
2-Week	0.280	2-Week	0.310
1-Month	0.290	1-Month	0.300
3-Month	0.300	3-Month	0.310
AGENCY REPOS		i-REPO <sup>SM</sup> INDEX	
O/N	0.280	10:00 AM	0.210
2-Week	0.290	3:00 PM	0.208
1-Month	0.290		
3-Month	0.300		

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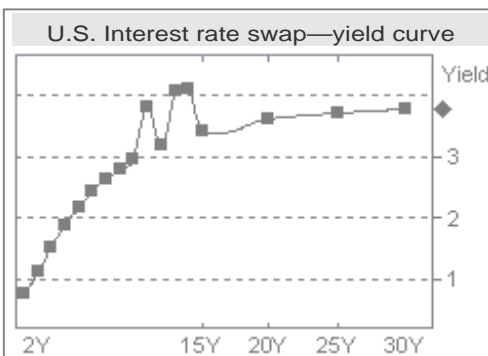
	SPREAD		RATE	
2-Year	15.25	19.25	0.77	0.80
3-Year	18.75	22.75	1.13	1.15
5-Year	16.50	20.50	1.87	1.89
7-Year	3.50	7.50	2.45	2.45
10-Year	-4.25	-0.25	2.97	2.96
30-Year	-31.75	-27.75	3.76	3.75

FUTURES

	PRICE	CHANGE
CBOT 5 yr	119.16	0.45
CBOT 10 yr	122.91	0.58
CBOT 30 yr	126.91	0.56

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.200	0.240	-	-
1-Month	0.300	0.400	0.187	0.197
3-Month	0.400	0.600	0.187	0.197
6-Month	0.550	0.700	0.190	0.200
12-Month	0.900	1.200	0.253	0.263



CURRENCIES

	BID	ASK
Euro	1.2977	1.2980
Sterling	1.5576	1.5580
JP Yen	87.42	87.44
Swiss Franc	1.0579	1.0582
Can Dollar	1.0381	1.0388
Mexico	12.7034	12.7084

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

Open	0.2100	1m	0.3217
High	0.2100	3m	0.4823
Low	0.1300		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1.125	30/07/2012	10 9	0.72
3-Year	1.625	15/04/2013	3 2	0.97
5-Year	2.375	28/07/2015	22 21.5	1.93
7-Year	5.125	18/10/2016	3 -	2.44
10-Year	-	-	- -	4.58
30-Year	6.625	15/11/2030	33 27	4.41

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD	YIELD
2-Year	1.125	27/07/2012	11 10	0.73
3-Year	1.25	20/08/2013	18 17.5	1.12
5-Year	2.875	09/02/2015	6.5 -	1.77
7-Year	5.25	15/09/2016	0 -	2.41
10-Year	3.75	27/03/2019	8 -	3.08
30-Year	6.25	15/07/2032	30 27	4.38

Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	4.0	104.0800	104.0800	2.732
FHLMC	4.0	104.0800	104.0900	2.708

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	4.5	104.0500	104.0600	2.969
FHLMC	4.5	104.0420	104.0460	2.941
GNMA	4.5	104.3170	105.0030	3.314

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

Nondefense Capital Goods Ex-Aircraft: Orders and Shipments  
3-month moving averages in blns of dollars



## TODAY'S TOP NEWS

**U.S. durable goods orders fall, but business spending up**

New orders for U.S. manufactured goods like cars and planes fell unexpectedly for a second straight month in June, posting the largest drop since August in a sign economic recovery cooled in the second quarter.

Durable goods orders dropped 1.0 percent after falling 0.8 percent in May, surprising financial markets that had expected a 1.0 percent increase.

But orders for non-defense capital goods excluding aircraft, a proxy for business spending, unexpectedly rose 0.6 percent in June after increasing by an upwardly revised 4.6 percent in May. Durable goods inventories rose 0.9 percent, increasing for the sixth straight month. Shipments fell 0.3 percent in June. Separately, demand for loans to buy homes rose for the second straight week to the highest level since the end of June, but hovered just above 13-year lows, the MBA said. Home purchase loan demand increased 2.0 percent last week, but rising mortgage rates saw applications for refinancing falling 5.9 percent. Meanwhile, the Fed's latest Beige Book summary of national economic conditions pointed to a less-than-booming recovery with sluggish housing markets and sales of costly items like new cars weakening.

**SEC should permanently change ABS rule, ASF says**

The U.S. SEC should permanently change its rules on new issue ratings so asset-backed securities match other bonds, the American Securitization Forum's executive director said.

Credit rating agencies are refusing to allow ABS issuers to use their ratings in registration statements out of fear that a new U.S. financial regulatory reform act exposes them to increased liability. The liability applies if they consent to have their ratings used in SEC filings.

For now, the SEC has allowed a six-month grace period for issuers to sell ABS deals without including the ratings in registration statements. The grace period was an attempt by the SEC to free the frozen ABS market. "The SEC could change their rule" known as Reg AB, specifically Items 1120 and 1103, ASF Executive Director Tom Deutsch told Reuters. The rule requires ABS ratings to be included in prospectuses. Corporate and municipal bond markets aren't subject to this rule.

Banks, which dominate credit card ABS, have access now to cheap deposit funding but will likely return to securitizations when depositors' savings rate falls, he said.

**U.S. mortgage brokers to be fingerprinted, registered**

Mortgage loan originators will have to be fingerprinted and sign up to a central registry to do business in future, according to final rules issued by the Federal Reserve and other regulators.

The rules are part of the Secure and Fair Enforcement for Mortgage Licensing Act of 2008, also called the S.A.F.E. Act.

Mortgage brokers came under tough scrutiny in the wake of the 2007-09 financial crisis, with some lawmakers and regulators sharply critical of underwriting standards and practices that were seen as so loose they helped foster a housing price bubble.

The S.A.F.E. Act specifies that mortgage brokers who are employees of agency-regulated institutions must register with the Nationwide Mortgage Licensing System and Registry.

The final rules take effect on Oct. 1 and it is anticipated that the registry could start accepting registrations as early as Jan. 28, 2011. Meanwhile, Fannie Mae is emphasizing safer, long-term, fixed-rate loans and asking lenders to make loans on homes with better appraisals to borrowers with better credit and better documentation of income.

**Cutting U.S. deficit a matter of timing - Orszag**

White House budget chief Peter Orszag said it would be "foolish" to cut the U.S. deficit while growth was still frail, but reckless not to significantly shrink the budget gap over the next five years.

Orszag told an audience at the Brookings Institution, that failing to take real steps toward closing the record U.S. budget gap would do as much harm to the economy as withdrawing fiscal stimulus now.

"It would be foolish to dramatically reduce the deficit immediately, because that would choke off the nascent economic recovery. But it would be equally foolish not to reduce the deficit significantly by say, 2015, because that would imperil continued economic growth at that point," he said.

The White House projects a record \$1.47 trillion budget deficit this year, or 10 percent of U.S. GDP, but plans to halve that amount to 5 percent by 2013.

Orszag said this reflected a strong preference among investors for the safety of U.S. sovereign debt, and yields would probably rise as investors shifted their money back toward the private sector.

**U.S. 5-year debt auction draws strong demand**

The U.S. government sold \$37 billion worth of five-year debt, with investors shrugging off low yields and high prices to bid strongly for the bonds on offer.

The five-year sale attracted bids worth 3.06 times the amount on offer, well above the historical average of 2.34 times and the strongest in nearly four years.

Primary dealers took 41 percent of the sale, compared to their historical average of nearly 62 percent and their six-month average of about 45 percent. Foreign central bank and large institutional investor demand appeared about average, based on the indirect bidder category, which accounted for 47 percent of the sale. This was close to the average of 47.5 percent in the auctions since June 2009, which has become a benchmark for comparisons because of changes in calculations that affected this category, but a bit above their six-month average of 43 percent. The recently growing direct bid accounted for 11 percent of the sale, above its 8.34 percent average since June 2009.

Investors are watching bond auctions closely, given a burgeoning U.S. budget deficit brought on by a costly rescue of the financial sector and efforts to stimulate the economy.

**ECB lays out new sliding scale of collateral haircuts**

The ECB toughened up its lending rules, saying that from next year banks will face higher penalties if they use weaker-rated assets as collateral to borrow ECB cash.

The ECB's new sliding-scale of "haircuts" will depend on asset class, maturity and credit rating. It will come into force at the start of next year and cover most collateral accepted by the ECB.

Haircuts for sovereign debt rated in the AAA to A- range have not been changed, however, while asset-backed securities, hard-to-value assets that critics say played a key part in the financial crisis, also keep their own stricter penalties. Haircuts will range from 0.5 percent for top-rated government debt to an eye-watering 69.5 percent for low-quality "inverse floaters".

Uncovered bank bonds will carry tougher penalties than under current rules if they have a year or more until maturity.

In addition, theoretically-valued covered and uncovered bonds will have an extra 5 percent add-on charge when the new rules kick in.



## TODAY'S TOP NEWS

**Goldman, Citi in \$788.5 mln CMBS deal-term sheet**

Goldman Sachs Group and Citigroup will sell a \$788.5 million commercial mortgage-backed security, according to a term sheet sent to investors, marking the largest deal of its kind as volume crawls back after the financial crisis.

The issue would be the sixth since the CMBS market re-opened in December, but just one of a few that include multiple loans. It is expected to price next week.

The new CMBS will be sold with an average loan-to-value ratio of 53.7 percent. More than three-quarters of the issue is supported by retail properties, including a \$100 million loan on New York City's 660 Madison Avenue.

Separately, BofA Merrill Lynch plans to sell a \$92 million bond backed by troubled reverse mortgages insured by the federal government, according to a term sheet obtained by Reuters. The bond is supported by 760 "home equity conversion" mortgages.

**Spain central govt H1 deficit down 24.7 pct y/y**

Spain's central government budget deficit, which excludes social security and regional governments, was down 24.7 percent in the first six months year on year, on higher tax income, the Treasury said.

The government passed a bill to reduce spending by 15 billion euros (\$19.49 billion) this year and next aim to reduce the total public deficit to 9.3 percent of GDP this year from 11.2 percent in 2009 in order to reach the goal of 3 percent of GDP by 2013, in line with EU recommendations.

The deficit totaled 29.8 billion euros in the period from January until June, equivalent to 2.83 percent of GDP compared to a deficit equivalent to 3.76 percent of GDP in the same period last year.

Spain's central government budget deficit totaled 18.8 billion euros in the period from January until May.

Separately, Hungary's prime minister said that one or two downgrades of the country's credit rating were likely after it broke ties with the IMF, but he said its finances were stable and the government should focus on growth.

**IMF gives ground on yuan exchange rate debate**

IMF has chosen not to call the yuan "substantially" undervalued, a move that recognizes China's efforts to free up its exchange rate and avoids friction with an increasingly influential shareholder.

The summary of an annual review of China's policies released yesterday omitted the contentious word, used by IMF Managing Director Dominique Strauss-Kahn as recently as June, which has long riled Beijing.

Several members of the IMF's 24-member executive board believed the Chinese currency was too cheap, the fund said.

But others said a structural reduction in the balance of payments surplus was already unfolding thanks to past steps to boost consumption, while others took issue with an assessment by IMF staff that the yuan was substantially undervalued.

Eswar Prasad, a senior fellow at Washington's Brookings Institution and a former IMF official, said IMF economists reckoned the yuan was still between 5 percent and 27 percent undervalued depending on the methodologies used.

**BoE's King says monetary stimulus should remain**

Britain's surprisingly strong second quarter growth reading does not mean the country's interest rate setters should put their foot on the brake, Bank of England Governor Mervyn King said.

Giving evidence to parliament's Treasury Committee, King said significant risks to the recovery remained and monetary policy could still go in either direction.

Since the last MPC meeting, data has shown the UK economy grew 1.1 percent in the second quarter, almost twice as fast as expected. King cautioned, however, that the recovery remained fragile. Sentance described the current monetary policy stance as "extreme" and reiterated his conviction that a fairly strong recovery was under way. Separately, banks should have plenty of time to build up capital buffers to meet stricter global rules so they can do more to help smaller firms grow, Mervyn King said. King and his peers endorsed new "Basel III" bank capital and liquidity rules earlier this week to help avoid banks needing state aid again in a future crisis.

## NEXT UP

**U.S. TREASURY OUTLOOK****Dealers betting on sweet 7-yr auction**

Primary dealers say the success of this week's auctions of two- and five-year U.S. Treasury notes bodes well for tomorrow's sale of seven-year notes.

Despite the rebound Treasury prices saw after the \$37 billion five-year auction, some dealers expect the seven-year auction high yield to be in line with or even a little lower than the yield at which seven-year notes trade simultaneously in the open market.

That relationship appeared during the auctions of two-year notes and five-year notes held Tuesday and Wednesday, respectively.

The seven-year note has divided traders into two camps: one sees the seven-year as a particularly attractive maturity; the other finds it awkward.

Foreign buyers and fund managers have warmed to the seven-year note. Direct bidders have taken down an average of 12 percent over the past six auctions, while indirects have taken 49 percent, on average.

In late June, directs took 9.8 percent while indirects, often seen as a proxy for foreign central banks, took down 51 percent.

**POLL-ECB to hold rates steady well into next year**

ECB will likely wait until late 2011 before hiking interest rates, according to a Reuters poll of over 70 economists who stayed cautious in July despite some encouraging economic data.

Median forecasts showed the ECB's main refinancing rate on hold at 1.0 percent until the third quarter of next year, when it is seen rising to 1.25 and then 1.50 percent by the end of 2011 -- unchanged from last month's poll.

And for the first time since the ECB cut its benchmark rate to a record low 1.0 percent in 2009, not one economist in the sample forecast a rate rise by the end of 2010. One year ago, more than two-thirds of economists were expecting one.

No economist forecast a rate hike at the ECB's August meeting and they gave only a one-in-ten chance of one before the end of the year. Thirty-three out of 44 economists who answered extra questions said the stress tests would prompt more capital raising among the 91 banks at large -- not just the ones that failed -- and by 10 billion euros.

More than two-thirds agreed that the worst was over in the European sovereign debt crisis following the conclusion of the tests, although many economists said budget austerity measures have yet to hit economies hard.



## DEEP DIVE Commentary and Analysis

## ANALYSIS-Economy struggles to wag its financial tail

By Mike Dolan

There has been just an inkling in recent weeks that financial markets might start to take their lead from the 'real' economy again after three years of being tossed about by their own panics and periodic exuberance.

Since the finance industry flailed into its crisis of confidence, doubting its own practitioners and the governments who became over-dependent on them, it has been almost impossible for households and companies to work out what markets are trying to predict about production, employment and consumption.

The net result has been the tail wagging the dog.

Guess the ephemeral mood of global markets six months hence -- voracious risk appetite or bunker-seeking safety -- and you might just stand a chance of predicting where businesses, consumers and policymakers would be forced to follow.

And while PIMCO asset managers predict a post-crisis 'new normal' of years of sluggish growth and policy angst, many yearn for an 'old normal' where finance reflects, rather than dictates, what is happening in the real economy where people produce and consume goods and services.

## A VERY FINANCIAL COUP

For some, the credit crisis and aftermath had been fomented for decades by a more than a doubling of financial services to some 7.5 percent of the U.S. economy in the 40 years to 2007.

"The 3 percent of GDP that was made up of financial services in 1965 was clearly sufficient to the task, the proof being that the decade was a strong candidate for the greatest economic decade of the 20th century," Jeremy Grantham, Chairman of Boston-based asset manager GMO, told clients this month.

Lauding this month's U.S. financial regulation bill, he added: "The extra 4.5 percent would seem to be without material value except to the recipients. Yet it is a form of tax on the remaining real economy and should reduce by 4.5 percent a year its ability to save and invest, both of which did slow down."

Former International Monetary Fund chief economist Simon Johnson's 2009 Atlantic magazine essay, "The Quiet Coup", took a more conspiratorial view of the same phenomenon in sketching the lobbying power of the financial industry over that period.

Johnson estimated U.S. financial sector profits, which had never topped 16 percent of overall corporate profits in the decade to 1985, soared to 41 percent by the noughties. Average financial sector compensation as a share of the average in other industries almost doubled to 181 percent.

There was a similar development in Britain, where financial services had reached 8.5 percent of total output just before the crisis.

Deregulation, privatization, trade globalization and demographic trends were all catalysts for this growth in finance and the current regulatory backlash against the banks is unlikely to return the sector to its 1960s size.

But if knocking the froth off finance allows a more even relationship between real economic trends and financial markets, there may be a chance of tempering the endless boom and busts.

## CHANGE AFOOT?

Is there any sign of that happening right now? Well, just an inkling.

In the past three years, financial and investment flows have been violently herded in and out of "safe-haven" cash and liquid assets, correlations zoomed between all asset classes and geographic regions, and risk gauges -- largely volatility measures --

careened from historic lows to highs and back again.

This mass behavior had been building for 20 years. Computer trading strategies supercharged the effect over time.

Yet as this year's euro zone sovereign debt crisis ebbs into the second half of the year, the herd seems for now to have stopped stampeding from its own rifle shots and may be listening more carefully to the underlying economy again.

Mindful of near-zero interest rates in cash, an expected dash back to safe-haven money market funds never really materialized during the worst of the euro crisis in April and May and 2010 outflows from these funds are still close to half a trillion dollars.

Partly as a result, stresses evident in lock-step asset correlations have ebbed and investors seem easier with idiosyncratic trends in selected stocks and credits.

Equity volatility has halved from April/May peaks and quartered from post-Lehman Brothers highs in 2008 and is holding closer to 20-year averages just above 20 percent rather than returning to unrealistic pre-2007 levels in single digits.

Even the world's main exchange rates between the U.S. dollar and euro -- long captive to "risk on/risk off" swings -- are starting to reflect interest rate gaps more than stress.

For active and diversified investors, this is how it is supposed to be and allows them to do what it says on the tin.

To be sure, we've been here before. But there are rays of hope for some return to old normals.

## ANALYSIS-Euro rally may be entering last lap

By Steven C. Johnson

The euro has sizzled in July but will cool down before the summer weather does as markets brace for an extended period of sluggish euro zone growth.

The euro entered the month trading around \$1.21, not far removed from June's trough of \$1.1876, its lowest since 2006. Investors feared debt crises in several peripheral euro zone countries might actually unravel the European monetary union. It has since vaulted above \$1.30. Traders say real money investors, including central banks, have driven the move, buying euros and higher-yield currencies such as New Zealand's dollar to boost short-term returns.

Oversold euro conditions and some weak U.S. economic data that dashed expectations of higher U.S. interest rates this year helped spark the short squeeze. Last week's stress tests, which gave most euro zone banks a clean bill of health, and smooth Greek and Spanish debt auctions combined to soothe nerves.

Data from the Commodity Futures Trading Commission showed bets against the euro at a record in May, though they have been scaled back since, with speculators only marginally short euros in the week to July 20.

But at some point, fundamentals will reassert their sway on exchange rates. With the European Central Bank expecting the euro zone to grow by no more than 1.3 percent this year and 2.2 percent next, a euro well above \$1.30 may be a bit of a stretch.

"A lot of people were short euros and have been knocked out of their positions, and there was a lot of money behind this recent move out of safe havens to pick up yield. But soon the euro will get too high, and Europe can't sustain that," said Sebastien Galy, senior strategist at BNP Paribas in New York.

"We see it rising to \$1.3150 -- \$1.35 is a super-aggressive target -- but then we think the fundamental story will come into play, so nobody is that keen on pushing it much higher."

Shaun Osborne, a currency strategist at TD Securities in Toronto, said once the euro broke above \$1.24 earlier this month, technical indicators suggested it could rally to the \$1.31-\$1.32

## DEEP DIVE Commentary and Analysis

area.

"But people are not entirely confident the euro can continue to rally," he said. "At best, it appears to be short-covering rather than people going outright long the euro, and medium-term, we think the euro is still going to fall."

But while euro short-covering against the dollar may be fading, Steven Englander, Citigroup's global head of G10 currency strategy, said the euro's spike against the Swiss franc seems to be gaining momentum. The pair was last near \$1.38, up from around \$1.3250 in early July, and Englander says a move to \$1.40-\$1.4250 could cause more pain for franc longs.

"The rate structure has shifted so much in the euro's favor that we are close to entering into that range, so there may be the risk of quick capitulation in long franc positions," he wrote in a note to clients.

Galy said he expects the euro rally to fizzle before that point. "The market's still heavily long Swiss francs, so this is still a short-covering exercise, but we expect it to be over around 1.40 francs," he said.

## EURO CARRY TRADE

BNP Paribas expects the euro to end 2010 at \$1.08, above an earlier call for parity but still well off its current level of \$1.2980.

Galy said global investors will start to favor it as a funding currency to finance carry trades, which in this case would involve using cheaply borrowed euros to finance more lucrative trades in higher-yielding currencies and assets.

In recent years, that role has been filled by the yen, with its perennially low interest rates, and the dollar. The latter became an attractive funding currency after the Federal Reserve cut interest rates to near zero to help the U.S. economy rebound from recession.

Galy said the yen will remain a favored funding currency for Japanese-based investors but expects the euro to displace the dollar as a funding currency for others.

"The U.S. has the potential of getting out of some of its economic issues, but Europe will underperform for a long time," he said. "Hedge funds were burned once on short euro positions, but we're still suggesting they sell the top side in euro/dollar as a source of funding."

Citigroup G10 currency strategist Michael Hart said a euro dip below \$1.20 looks unlikely now that markets are no longer afraid that Europe's debt problems will destroy the euro zone.

But he said a further euro rise would require yield differentials to move in its favor, "which is difficult to envisage in the absence of an actual policy rate move."

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