INSIDE DEBT

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Wednesday, August 4, 2010

CHART OF THE DAY

U.S. services sector

The Institute for Supply Management reported increased growth in the services sector to 54.3 in July from June's 53.8, showing unexpectedly stronger growth.

TODAY'S TOP NEWS

- U.S. private sector job growth remains tepid
- U.S. Treasury trims debt sales, doubts on future cuts
- U.S. tax cuts for wealthy must end - Geithner
- European banks see hazards as bad debts fall
- U.S. Senate bill to send states money advances
- Obama says "long battle" in Gulf close to end
- U.S. home loan purchase demand up 3rd straight week
- Euro zone services growth strong but patchy
- UK services slowdown raises recovery fears, pound dips
- China Q3 GDP to slow to 9.2 pct yr/yr-think tank

ECON WATCH

FOR THURSDAY AUGUST 5

ET		Indicators	Unit	Reuters	Prior
6:00	DE	Industrial orders mm	%	1.5	-0.5
7:00	GB	BoE rate decision	%	0.50	0.50
7:45	EZ	ECB rate decision	%	1.00	1.00
8:30	US	Initial claims	k	455	457
8:30	US	Continuing claims	mln	4.54	4.565
8:30	CA	Building permits	%	1.8	-10.8

MARKETS TODAY

TODAY'S TOP STORY: U.S. companies hired more workers in July but the gains are too slow to reduce unemployment and spur the economy significantly, reports showed.
For more please click here

TREASURIES: The prices of U.S. government debt fell as slightly better-than-expected economic data buoyed stocks, interrupting a recent rally in Treasuries that drove two-year note yields to record lows.

- The Treasury will sell $34 bln of 3-yr notes next week, down from $38 bln at its last quarterly refunding. It will sell $24 bln of 10-yr notes on Aug. 11 and $16 bln of 30-yr bonds on Aug. 12.
- 2-yr notes shed 2/32 to yield 0.57 pct, up from 0.54 pct.
- 10-yr Treasury notes lost 14/32 in price to yield 2.96 pct, while 30-yr bonds fell 23/32 yielding 4.08 pct.
- The spread between the 10-yr note's and 30-yr bond's yield were trading at 113 bps while 2-10's yield curve steepened by about 2 bps to 239 bps.

FOREX: The dollar rebounded from an eight-month low against the yen and rose against the euro as encouraging U.S. employment and service sector data prompted traders to unwind bets against the U.S. currency.

- The dollar rose 0.49 pct to 86.26 yen after falling to 85.33 yen, its lowest since November.
- The euro fell 0.52 pct to $1.3163, off Tuesday's three-month high of $1.3261 while euro gained 0.06 pct to 113.54 yen.
- The dollar fell 1.26 pct to 1.0524 Swiss francs and sterling fell 0.36 pct to $1.5888.

CORPORATES: U.S. corporate bonds spreads tightened with slightly better-than-expected employment and service sector data, keeping alive a four-week rally.

- The CDX.IG-14 index tightened to 99 bps from 100 bps.
- However, new issues from AMB Property and Magellen Midstream Partners were priced at a low end of guidance.
- The financial sector was the most actively traded segment of the investment grade corporate bond market.

STOCKS: U.S. stocks rose in thin trade as retailers' earnings and a report showing a slight improvement in private employment increased optimism ahead of Friday's payrolls report.

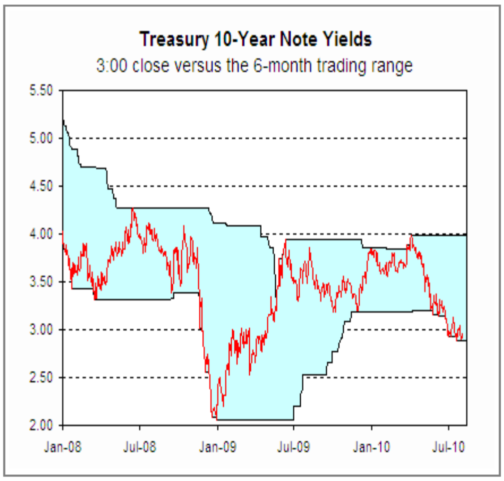
- Dow rose 0.42 pct to 10,680.58, S&P was up 0.61 pct at 1,127.25 and Nasdaq gained 0.88 pct to 2,303.57.
- Shares of Priceline.com soared 21.95 pct, Dendreon was up 17.59 pct.
- Goldman Sachs added 2.10 pct and Barnes & Noble shot up 19.16 pct and Amazon.com jumped 4.22 pct.

C & E: U.S. crude oil fell as a stronger dollar and weak gasoline futures weighed on crude futures and offset a government report of falling crude oil inventories.

- U.S. crude oil was down 0.12 pct to $82.45 per barrel.
- Gold advanced 0.7 pct to $1,193.6 an ounce.
- Reuters-Jefferies index gained 0.85 pct to 278.98.

- For MARKET SNAPSHOT click here
- For NEXT UP click here
- For DEEP DIVE click here

MARKET SNAPSHOT as of 3:00 pm EST



REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.300	O/N	0.310
2-Week	0.290	2-Week	0.300
1-Month	0.300	1-Month	0.300
3-Month	0.300	3-Month	0.310
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.300	10:00 AM	0.230
2-Week	0.300	3:00 PM	0.233
1-Month	0.300		
3-Month	0.300		

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

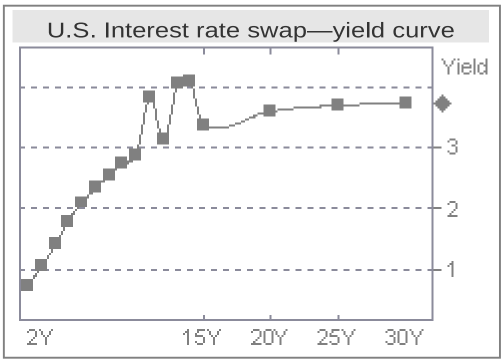
	BID	ASK	BID	ASK
O/N	0.210	0.240	-	-
1-Month	0.280	0.380	0.175	0.185
3-Month	0.350	0.550	0.176	0.186
6-Month	0.520	0.650	0.178	0.188
12-Month	0.880	1.200	0.223	0.233

TREASURIES <5> <500>

	BID	ASK	YIELD	CHANGE
1-Mo Bill	0.165	0.13	0.167	0.008
3-Mo Bill	0.150	0.140	0.152	0.003
6-Mo Bill	0.190	0.185	0.193	-0.003
1-Year	0.265	0.240	0.269	0.006
2-Year	100.109	100.141	0.570	-0.051
3-Year	100.461	100.492	0.842	-0.152
5-Year	100.656	100.703	1.613	-0.273
7-Year	100.344	100.391	2.321	-0.313
10-Year	104.656	104.703	2.948	-0.289
30-Year	105.266	105.344	4.068	-0.305

IR SWAPS <19901>

	SPREAD		RATE	
2-Year	15.50	19.50	0.72	0.75
3-Year	21.75	25.75	1.06	1.08
5-Year	15.00	19.00	1.76	1.77
7-Year	3.25	7.25	2.35	2.36
10-Year	-5.00	-1.00	2.91	2.90
30-Year	-32.25	-28.25	3.74	3.73



EQUITIES

	INDEX	CHANGE
DJIA	10674.30	37.92
NASDAQ	2298.46	14.93
S&P 500	1125.84	5.38

OIL

	PRICE	CHANGE
NYMEX	82.4	-0.2
BRENT	76.4	1.1

EURODOLLAR FUTURES

	CLOSE	CHANGE
Aug-10	99.605	0.000
Sep-10	99.605	-0.005
Dec-10	99.555	-0.020
Mar-11	99.475	-0.035

FUTURES

	PRICE	CHANGE
CBOT 5 yr	119.12	-0.28
CBOT 10 yr	123.23	0.03
CBOT 30 yr	128.00	-0.13

CURRENCIES

	BID	ASK
Euro	1.3170	1.3172
Sterling	1.5895	1.5900
JP Yen	86.21	86.24
Swiss Franc	1.0517	1.0520
Can Dollar	1.0167	1.0172
Mexico	12.5342	12.5404

FED FUNDS / NYFR SM - 10AM

FED FUNDS		NYFR SM - 10AM	
Open	0.2200	1m	0.2912
High	0.2700	3m	0.4275
Low	0.1400		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	30/07/2012	15	14.5	0.71
3-Year	1.625	15/04/2013	8	6.5	0.92
5-Year	2.375	28/07/2015	22	21.5	1.83
7-Year	5.125	18/10/2016	0	-	2.32
10-Year	-	-	-	-	4.57
30-Year	6.625	15/11/2030	-	25	-

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	27/07/2012	15.5	14.5	0.72
3-Year	1.25	20/08/2013	19	18.5	1.03
5-Year	2.875	09/02/2015	3.5	-	1.64
7-Year	5.25	15/09/2016	-3	-	2.29
10-Year	3.75	27/03/2019	5	2	3
30-Year	6.25	15/07/2032	29	25	4.36

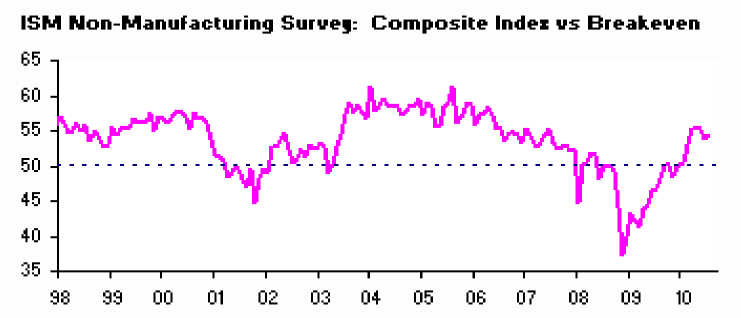
Active MBS 15YR

	CPN	BID	ASK	YIELD
FNMA	4.0	104.1910	104.1950	2.573
FHLMC	4.0	104.1910	104.1950	2.530

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	4.5	104.1610	104.1650	2.726
FHLMC	4.5	104.1400	104.1400	2.693
GNMA	4.5	105.1320	105.1360	2.999

Wrightson ICAP SM Chart of the Day



ICAP
THOMSON REUTERS

TODAY'S TOP NEWS

U.S. private sector job growth remains tepid

U.S. companies hired more workers in July but the gains are too slow to reduce unemployment and spur the economy significantly, reports showed.
U.S. private employers added 42,000 jobs in July, payrolls processor ADP Employer Services reported.
Separately, the ISM reported increased growth in the services sector in July, while its employment gauge for the sector indicated expansion for only the second time since December 2007.
Employment levels are considered key to a pickup in consumer spending and to boosting overall U.S. economic growth, which has shown signs of weakness in recent months.
The Labor Department report is expected to show non-farm payrolls fell by 65,000 in July. Private-sector payrolls are seen rising a modest 90,000 in Friday's data, and the unemployment rate is expected to climb to 9.6 percent, from 9.5 percent in June.
In its report on activity in the services sector, the ISM said its services index rose to 54.3 in July from June's 53.8, showing unexpectedly stronger growth. The reading for backlog orders dipped to 52.0 from 55.5 in June.
A separate report showed the number of planned layoffs at U.S. firms rose 6.0 percent in July, marking the third straight month of increased layoffs.

U.S. tax cuts for wealthy must end - Geithner

The Bush administration's "misguided" policies are to blame for huge U.S. fiscal deficits and tax cuts for the wealthiest Americans must end, U.S. Treasury Secretary Timothy Geithner said.
Striking a note of austerity in prepared remarks to a conference, Geithner said extending tax cuts for those making over $250,000 a year will only add to deficits.
Tax cuts enacted during the Bush administration are scheduled to expire at the end of this year and are a hot button political issue. Republicans have ramped up their rhetoric in recent days. They accuse Democrats of jeopardizing the economy if all the tax cuts are are not extended.
Obama and most Democrats want to extend them for individuals making less than $200,000, or families earning less than $250,000 - about 97 percent of all Americans.
Congress must take action to extend any part of the tax cuts. Dividend rates will rise from 15 percent to 40 percent with no action, a key source of stress among investors.

U.S. Senate bill to send states money advances

A bill to send U.S. states billions of dollars for schools and healthcare advanced in the Senate, bolstering states' hopes for federal help in confronting enormous budget holes.
The Senate voted 61-38 to close debate and move the legislation toward a final vote. Republicans attempted to kill the bill, saying it violated U.S. budget rules, but the Senate voted to waive budget rules and allow it to proceed. Democrats treated the final vote, which will likely take place before tomorrow evening, as symbolic and proceeded as if the legislation had passed. The legislation would give states $16.1 billion for Medicaid, the healthcare program for the poor, and $10 billion for teaching jobs. Democratic leaders in the Senate and House have been discussing whether the House should be called back to session to pass whatever jobs bill clears the Senate.
Separately, Harvard University law professor Elizabeth Warren will play a role in consumer protection regardless of whether she is chosen to lead a new U.S. consumer financial agency, a Treasury official said.

U.S. Treasury trims debt sales, doubts on future cuts

The U.S. Treasury again cut the size of debt offerings, citing stronger tax revenues, but warned it may not be able to keep trimming sales at the same rate due to doubts about economic recovery.
The treasury cut the size of a three-year note offering by $4 billion to $34 billion in the overall quarterly refunding that will see Treasury offer a total $74 billion in three- and 10-year notes and 30-year bonds next week.
It was the second successive quarterly refunding, following last May's, in which Treasury reduced the amount of its overall offering as tax revenues rose. It came with a caution that "risks to the recovery have risen" so that future reductions may be smaller. With the economy gradually recovering from recession, and awash in liquidity due to the money that the Federal Reserve pumped into it during the 2007-2009 financial crisis, Treasury also appeared to be preparing for possible increased demand for debt that offers a hedge against inflation.
Treasury said it anticipated sales of Treasury-inflation Protected Securities rising steadily this year and in 2011.

European banks see hazards as bad debts fall

Concerns about new banking regulations and a shaky economic recovery tempered optimism over improving results from more of Europe's top banks.
The results mostly showed higher-than-expected profits thanks to shrinking bad debts.
The faster than expected fall in bad debts is outweighing a slump in investment banking income following Greece's economic crisis, a sharp contrast to the first quarter when investment banking drove record results.
Societe Generale's second-quarter profit was nearly 50 percent higher than estimates, despite income from investment banking sinking by more than a third.
The French bank forecast losses for the year from risky assets would come in at the bottom end of its previous guidance.
Asian-focused Standard Chartered posted record profits to beat forecasts, while Britain's Lloyds returned to profit as impairments halved, posting a 5 percent rise in net income.
Postbank bucked the trend by raising provisions for bad loans and scrapping profit targets despite reporting profits which met expectations.

Obama says "long battle" in Gulf close to end

BP claimed "a significant milestone" in efforts to plug its broken Gulf of Mexico well for good, as the U.S. government said nearly three-fourths of the spilled crude been dispersed or captured or had evaporated.
After months of setbacks in efforts to permanently plug the well, BP said heavy drilling mud injected into it was stemming the flow of crude. The next step in the "static kill" procedure will be to pump in cement behind the mud as a seal.
The static kill is part of a two-pronged strategy to kill the well for good. A relief well is due to intercept the ruptured well shaft in mid-August so that more mud and cement can be injected into it. The financial implications for BP's continued cleanup efforts were not immediately clear. Government officials have said in the past that it will take years to fully repair the damage inflicted by the spilled oil, which seeped into ecologically sensitive wetlands and marshes.
Anadarko Petroleum Corp, one of BP's partners in the well, said on Tuesday it had secured $6.5 billion in loan commitments, in part to pay for its liabilities.

TODAY'S TOP NEWS

U.S. home loan purchase demand up 3rd straight week

The demand for U.S. mortgage applications to purchase homes rose last week for a third straight week as interest rates tumbled, the MBA said.
The low rates also buoyed demand for home refinancing loans, with activity rising in five out of the past eight weeks, the industry group said. The MBA said its seasonally adjusted index of mortgage applications increased 1.3 percent in the week ended July 30. The four-week moving average of mortgage applications was up 0.3 percent. Borrowing costs on 30-year fixed-rate mortgages, excluding fees, averaged 4.60 percent. Interest rates were also below their year-ago level of 5.17 percent. The seasonally adjusted purchase index increased 1.5 percent. Demand, however, is down about 40 percent since the tax credit expiration. The MBA's seasonally adjusted index of refinancing applications increased 1.3 percent. The MBA said fixed 15-year mortgage rates averaged 4.03 percent.

Euro zone services growth strong but patchy

The euro zone's dominant service sector picked up speed last month, a survey showed, allaying fears of a double dip recession, but strong growth in Germany and France masked weakness in southern Europe.
Markit said its final Eurozone Services PMI rose to 55.8 in July from June's 55.5, showing a slight downward revision from a preliminary estimate of 56.0.
Germany's reading of 56.5 was higher than June's 54.8 it was well below a flash estimate of 57.3 given late last month. The euro zone services output price index remained stubbornly below the break-even mark for the 21st month at 47.9, although up from June's 47.4, as firms continued to chop prices to attract business. Even so, the composite PMI index rose to 56.7 this month from 56.0 in June, in line with flash estimates.
The composite employment index jumped to 51.4 last month from June's 50.6, its highest reading since April 2008.
Meanwhile, Euro zone retail trade was flat in June, while on a year-on-year basis, retail sales in the euro zone rose 0.4 percent following revisions to the previous month's data.

UK services slowdown raises recovery fears, pound dips

Britain's services industry grew at its slowest rate in 13 months in July, a survey showed, as worries about spending cuts weighed on confidence, raising fears about the strength of economic recovery.
The Markit/CIPS services PMI headline activity index fell to 53.1 last month from 54.4 in June, its lowest level since June 2009.
An equivalent survey of manufacturers this week also showed a slowdown in activity, and together the figures indicated that the 1.1 percent growth recorded between April and June would not be sustained later in the year as the spending cuts bite.
A separate survey released indicated the cuts are already starting to bite, with the latest KPMG/REC report on jobs showing permanent hiring at its slowest in nine months due to a decline in demand for healthcare workers. The business expectations component was only modestly above a 15-month low at 64.9.
Separately, a survey from Halifax showed house prices rose 0.6 percent last month.

China Q3 GDP to slow to 9.2 pct yr/yr-think tank

China's economy will cool further this quarter as fiscal pump-priming starts to fade and the restocking cycle draws to a close, a government think tank said.
Annual GDP growth will slow to 9.2 percent from 10.3 percent in the second quarter and 11.9 percent in the first, the State Information Centre said in a report published in official media.
The centre has previously forecast full-year growth of 9.5 percent, which would be close to the average for the past 30 years. The forecast is in line with private-sector projections.
A pair of manufacturing surveys released this week also signaled moderating growth. China has been steering monetary policy back to normal after an unprecedented surge in credit last year fanned fears by the start of 2010 that the economy could be overheating. The government has also clamped down hard on property speculation, fearing that prices in some cities had soared beyond the reach of most people and were feeding on themselves. The State Information Centre said other forces were at work, too.

NEXT UP

POLL-Euro rally to run out of steam as austerity bites

The euro's recent rally against the dollar will soon reverse as fiscal tightening and weak economic growth plague the common currency, the latest Reuters poll of foreign exchange analysts predicted. The poll of around 60 analysts, taken August 2-4, predicted the euro would be worth just $1.20 in a year's time -- not far from the four-year lows of below $1.19 seen in June and well below Tuesday's three-month high of $1.3262.
Separately, The Canadian dollar is expected to remain near current levels versus the U.S. currency for the next 12 months, reflecting the tug-of-war between a still-solid domestic economic recovery and a weaker global outlook, according to median forecasts in a Reuters poll.
The currency is expected to be at C$1.020 to the U.S. dollar, or 98.04 U.S. cents in one and six months' time, according to forecasts by 48 strategists in a monthly Reuters poll published.
Also, The Japanese yen, now trading near 15-year highs against the dollar, is close to peaking but its slide will be at a slightly slower pace than previously expected as recent gloomy U.S. data and prospects for extended low U.S. interest rates keep pressure on the greenback. A monthly Reuters poll of around 60 foreign exchange strategists taken Aug. 2-4 saw them scale back their forecasts for the dollar/yen. They saw dollar/yen trading at 86.8 in a month from now, 92 in six months and 97 in a year, compared with 89, 95 and 98 last month. The yen is currently trading at around 85.50 per dollar, not far off a 15-year high. That has raised alarm among policymakers that the currency's strength will weaken Japanese exports and add to deflationary pressures.

PREVIEW-BoE to hold rates as it weighs growth, CPI risks

The BoE's rate-setters will almost certainly keep borrowing costs at a record low in August and will likely leave policy loose for many months as they wait for more evidence the recovery is taking hold.
But the decision will mask what is likely to be a lively debate on how to resolve the opposing tensions on the economy from a fiscal squeeze at home and abroad, tight credit conditions and persistently high inflation.
All 61 economists polled by Reuters last week expect rates to stay at 0.5 percent, where they have been since March 2009, and most do not see a rate rise until the second quarter of 2011.

DEEP DIVE Commentary and Analysis

COLUMN-Stars aligning against dollar/yen

By John Noonan and Rick Lloyd

Dollar/yen is poised to hit a 15-year low below 84.82 as a drop in two-year Treasury yields to a record low, limited short positioning in the pair and the dollar's growing role as a carry funding currency all point to a further slide.

Comments from Federal Reserve Chairman Ben Bernanke and St. Louis Fed's James Bullard have stoked market expectations that the Fed may consider resuming quantitative easing efforts as soon as next week's meeting.

Signs that the U.S. economy is faltering and Bullard's view that the country is in danger of experiencing "Japan-style deflation" have resulted in the dollar falling against many currencies, including the yen.

The fall in U.S. Treasury yields has led to market players switching their preferred carry trade currency from yen to U.S. dollars, meaning that when the market is in "risk on" mode they sell USD/JPY rather than buy it.

If the market is in "risk off" mode, they buy JPY as a safe haven, leading to the notion that selling USD/JPY is a one way bet.

The mere mention of Japan-style deflation threatening the U.S. economy has driven the two-year Treasury yield to uncharted territory, touching a record low 0.52 percent this week and a mere 38 basis points over Japan's miniscule yields.

Adding to the upward pressure on the yen, new regulations limiting leverage in Japanese retail investor margin trading have led to those investors slashing short positions favoring higher-yielding currencies such as the Australian dollar.

Volumes on the Tokyo Financial Exchange have fallen by over 30 percent so far this week since the regulations took effect.

Yet more pressure has been added as traders target a large options barrier at 85.00, which market participants would like to take out before the release of U.S. non-farm payrolls data on Friday.

The idea of USD/JPY collapsing below technical and psychological support between 84.82 -- the 2009 low -- and 85.00 has encouraged opportunistic speculators to start building short USD/JPY positions.

But there is little evidence the market positioning has yet reached lopsided proportions, suggesting this drop has more room to run as long as Japanese authorities remain reluctant to step in to curb the yen's gains.

The latest weekly IMM data showed a small reduction of yen longs against the dollar, from near 41,000 contracts to 29,921 contracts. Most analysts agree long yen positions will increase should 84.80 give way.

While the reasons for being short USD/JPY are obvious, the risks to that view are not so straightforward.

First, the belief that Japanese authorities are powerless to stop the fall could be proved wrong, as it was in November when the yen last reached these dizzy heights and prompted the Bank of Japan to inject more liquidity into the money market at an emergency meeting, a move that appeared to target the yen.

Intervention in currency markets seems unlikely unless the pace of the decline accelerated, or the rate approached or broke the 80.00 level. The move down in dollar/yen has not been a sharp one, with one-month implied vol holding in a range around 11.5 percent and near levels of realized vol.

Authorities would also need agreement from the United States and Europe, which is highly unlikely to be granted, as the G7 continues to press China to free up its currency.

Second, U.S. payrolls data on Friday could have a large impact on U.S. Treasury yields and therefore on USD/JPY.

The correlation between USD/JPY and the Treasury/JGB yield spread is very strong, at a positive 0.93 on a 90-day basis, according to Thomson Reuters data.

Japanese investors involved in FX-linked structured products such as power-reverse dual currency notes are forced to sell USD/JPY every time the 10-year Treasury yield falls -- one factor behind the recent sell-off.

Thus with yields at such low levels, a strong non-farm payrolls report will definitely move USD/JPY up sharply.

But anecdotal evidence of large amounts of cash being parked in U.S. Treasuries is a danger to bond bulls, should equity markets break strong technical resistance that is found just above current prices.

S&P 500 touched 1,127 on Monday, right on the 100-day moving average and approaching the 61.8 percent Fibonacci at 1,140.

A break of the that Fibonacci resistance may well suck a lot of institutional money into equities, at the expense of Treasuries and to the benefit of dollar/yen.

Fiscal hurdles risk tripping peripheral euro recovery

By Ian Chua

A rebound in euro zone assets, including fringe government bonds, shows investors are starting to look past Europe's sovereign debt crisis but long-term fiscal hurdles pose risks for assets of the most debt-laden nations.

Fund managers are being selective about what they buy and some have opted to steer clear of peripheral euro zone debt, even at the expense of missing the recent rally, until austerity measures to rein in record fiscal deficits start to bear fruit.

They also want to see whether governments resist the political and public fallout from unpopular deficit-cutting measures before they start raising their holdings of peripheral euro zone assets across the board.

"It's all about whether the austerity packages can be implemented and sustained. We're waiting to see what is the economic impact and stemming from that what is the political impact," said Russell Silberston, head of global interest rates at Investec Asset Management.

Euro zone countries from Germany downwards have pledged to enact dramatic fiscal cuts but it is the bloc's southern flank -- notably in Greece, Portugal and Spain -- where the most dramatic surgery is required and there that the risk electorates may not accept the pain is largest.

Ireland, which also faced dramatic debts, made an earlier start on tackling them but faces additional burdens having bailed out two of its biggest lenders.

Bank stress test results in July, which showed only seven out of 91 European banks failed, were the latest in a series of confidence-boosting exercises going back to May when a $1 trillion emergency package, including a bond purchase program by the European Central Bank, was created to stabilize the euro.

Such steps have boosted the euro, compressed the premium investors demand to hold peripheral euro zone debt rather than German government bonds, reduced sovereign credit tensions, and helped European stocks rise and outperform U.S. stocks.

The measures have also helped to defuse the tension that had begun to surround each government debt auction in any of the peripheral euro zone countries, and yields even fell at Spanish and Portuguese auctions last month.

SUSTAINABLE RECOVERY?

That said, recent price moves have yet to reverse the bulk of decline seen in the past seven months.

This means the current rally could very well represent a correction from very bearish positions and at a time when markets are thinned by the Northern Hemisphere summer holidays.

DEEP DIVE **Commentary and Analysis**

"From the flows, and investor surveys it would appear that it is the covering of underweights, a lot of it from real money rather than any initiation of fresh long positions in the periphery," said Jack Kelly, Investment Director, Global Fixed Income, Standard Life Investments.

"A stopping out of "risk off" type trades from the hedge fund community has likely exacerbated the moves in fairly illiquid markets," he said.

The real test for euro assets will come when real money investors return in force next month, and when governments update their budget deficit forecasts.

"If the peripheral countries show good progress in deficit reduction, and the key political players continue to exhibit unity, then there is no reason why peripheral bonds cannot hold onto recent gains," said Martin Harvey, a fund manager at Threadneedle.

RELATIVE VALUE GAME

Having lived through the European debt crisis, investors will drill into the merits of euro zone member countries, rather than just buying or shunning their assets indiscriminately.

"We have added to positions in Italian bonds in the past few weeks, but remain cautious regarding the more risky names, such as Ireland and Portugal," said Threadneedle's Harvey.

Spanish bonds, which led the outperformance versus German Bunds, were starting to look extended on fundamental grounds, said Citi analyst Steven Mansell: "We would advise focusing on the stronger, non-core markets, notably Italy, for better relative performance potential."

For the euro, further long-term gains against the dollar are likely although driven more by deteriorating U.S. fundamentals. Near term, the single currency could struggle after a stellar rebound to around $1.32, from below $1.20 in early June.

"Next three months or so it could pull back towards $1.25," said Jan Lambregts, global head of financial markets research at Rabobank. "But on a 12-month horizon, we know that people are going to get a lot more worried about the debt situation in the U.S ... that could see euro dollar trade up towards $1.35-$1.40."

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

For questions or comments about this report, email us at:
inside.debt@thomsonreuters.com
or contact Chandra Ramarathnam on +91 80 4135 5899

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