

## CHART OF THE DAY

### Dollar/Yen



The U.S. dollar fell to a fresh 15-year low against the yen at 82.99, its strongest level since mid-1995. The yen has gained more than 10 percent against the dollar this year on recent weak data and record-low bond yields drove money away from U.S. assets.

## TODAY'S TOP NEWS

- U.S. retail sales gain eases new recession fears
- Bill to aid small-business advances in U.S. Senate
- AIG, U.S. repayment talks advancing -- source
- IMF head says Basel falls short on bank supervision
- S&P : Japan govt credit quality is "slowly sinking"
- Refunding risk diminishing for corporations-Moody's
- Obama edges toward decision on Warren as regulator

## ECON WATCH

FOR WEDNESDAY SEPTEMBER 15

| ET       | Indicators             | Unit | Reuters | Prior |
|----------|------------------------|------|---------|-------|
| 04:30 GB | Claimant count         | k    | -3.0    | -3.8  |
| 04:30 GB | ILO unemployment rate  | %    | 7.8     | 7.8   |
| 04:30 GB | Avg earnings (inc-bon) | %    | 1.7     | 1.3   |
| 05:00 EZ | Inflation, final mm    | %    | 0.2     | -0.3  |
| 05:00 EZ | Ex food & energy mm    | %    | 0.2     | -0.4  |
| 05:00 EZ | Ex food & energy yy    | %    | 0.9     | 1.0   |
| 08:30 US | Import prices mm       | %    | 0.3     | 0.2   |
| 08:30 US | Export prices mm       | %    | 0.2     | -0.2  |
| 08:30 US | Empire state index     | ind  | 8.0     | 7.1   |
| 09:15 US | Industrial output mm   | %    | 0.2     | 1.0   |
| 09:15 US | Cap utilization        | %    | 75.0    | 74.8  |

## MARKETS TODAY

**TODAY'S TOP STORY:** Sales at U.S. retailers posted their largest gain in five months in August on strong receipts at gasoline stations and clothing outlets, further assuaging fears of a double-dip recession.

**For more please click here**

**TREASURIES:** Government debt prices rose, as persistent worries about the economy and pending index changes rekindled bond purchases and pushed down longer-dated yields from one-month highs.

- 10-yr notes were up 22/32 to yield 2.67 pct, down from 2.75 pct. It reached 2.85 pct on Monday, which was the highest since Aug 6, according to Reuters data.
- 30-yr bonds rose 1-7/32 yielding 3.78 pct from 3.85 pct.
- 5-yr notes added 13/32 to yield 1.43 pct from 1.51 pct.
- 2-10's part of the yield curve flattened by 4 bps to 217 bps.

**FOREX:** The dollar sold off across the board, touching a 15-year low below 83 yen as a break of technical support levels in several pairs sparked a stampede out of the U.S. currency.

- The dollar fell to a 15-year low of 82.92 on electronic trading platform. It last traded at 83.09, down 0.74 pct.
- Euro rose 1.03 pct to \$1.3008 and added 0.29 pct to 108.1 yen.
- Australian dollar rose 0.66 pct to \$0.9413. Earlier, it rose as high as \$0.9458, its highest level since July 2008.
- Dollar fell 1.17 pct to 0.9954 francs. Sterling rose 0.88 pct to \$1.5559.
- Dollar index fell 0.94 pct to 81.144.  
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**CORPORATES:** Corporate bond spreads were steady near their narrowest levels since May after retail sales data alleviated fears about a double-dip recession, supporting demand for riskier assets.

- The CDX.IG-14 index widened by 1 bps to 104 bps.
- Ford Motor Credit launched a \$1.0 bln 5-yr note sale.
- America Honda Finance launched a \$1.75 bln. The offering includes \$250 mln of 3-yr notes expected to yield 87.5 bps over comparable U.S. Treasuries and \$1.0 bln of 5-yr notes expected to yield 110 bps more than Treasuries.

**STOCKS:** Stocks ended little changed after promising data from the retail sector was offset by a sell-off in bank shares as investors locked in recent gains.

- Dow fell 0.17 pct to 10,526.49 and S&P lost 0.07 pct to 1,121.07 and Nasdaq climbed 0.18 pct to 2,289.77.
- Shares of Best Buy jumped 6 pct to \$36.73 and Delta Air Lines rose 4.78 pct to \$11.18.
- S&P retail index rose 1.2 pct. KBW bank index fell 1.35 pct.

**C & E:** Gold hit record highs on the back of a sharply weak dollar and some agricultural markets rallied too, sending a broad commodities index to a six-week high.

- Gold rose 1.85 pct to 1,268.3 an ounce.
- U.S. crude oil fell 0.51 pct to \$76.8 per barrel.
- Reuters-Jefferies index added 0.93 pct to 280.13.

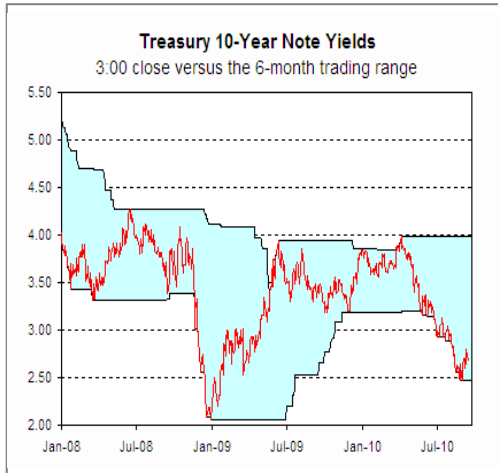
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- For MARKET SNAPSHOT click here
- For NEXT UP click here
- For DEEP DIVE click here



MARKET SNAPSHOT as of 3:00 pm EST



TREASURIES <5> <500>

|           | BID     | ASK     | YIELD | CHANGE |
|-----------|---------|---------|-------|--------|
| 1-Mo Bill | 0.110   | 0.075   | 0.112 | 0.009  |
| 3-Mo Bill | 0.150   | 0.140   | 0.152 | 0.008  |
| 6-Mo Bill | 0.200   | 0.180   | 0.203 | 0.004  |
| 1-Year    | 0.240   | 0.230   | 0.244 | 0.000  |
| 2-Year    | 99.750  | 99.781  | 0.504 | 0.078  |
| 3-Year    | 99.914  | 99.945  | 0.780 | 0.180  |
| 5-Year    | 99.133  | 99.180  | 1.432 | 0.422  |
| 7-Year    | 98.656  | 98.703  | 2.083 | 0.570  |
| 10-Year   | 99.625  | 99.688  | 2.668 | 0.750  |
| 30-Year   | 101.547 | 101.609 | 3.788 | 1.141  |

EQUITIES

|         | INDEX    | CHANGE |
|---------|----------|--------|
| DJIA    | 10563.65 | 20.58  |
| NASDAQ  | 2297.18  | 11.52  |
| S&P 500 | 1124.65  | 2.98   |

OIL

|       | PRICE | CHANGE |
|-------|-------|--------|
| NYMEX | 76.8  | -0.4   |
| BRENT | 79.1  | 0.1    |

EURODOLLAR FUTURES

|        | CLOSE  | CHANGE |
|--------|--------|--------|
| Oct-10 | 99.673 | 0.000  |
| Dec-10 | 99.600 | 0.000  |
| Mar-11 | 99.530 | -0.005 |
| Jun-11 | 99.440 | -0.005 |

REPURCHASE AGREEMENTS

| G/C          |       | MORTGAGE REPOS             |       |
|--------------|-------|----------------------------|-------|
| O/N          | 0.320 | O/N                        | 0.300 |
| 2-Week       | 0.280 | 2-Week                     | 0.300 |
| 1-Month      | 0.280 | 1-Month                    | 0.310 |
| 3-Month      | 0.300 | 3-Month                    | 0.310 |
| AGENCY REPOS |       | i-REPO <sup>SM</sup> INDEX |       |
| O/N          | 0.320 | 10:00 AM                   | 0.220 |
| 2-Week       | 0.300 | 3:00 PM                    | 0.224 |
| 1-Month      | 0.300 |                            |       |
| 3-Month      | 0.300 |                            |       |

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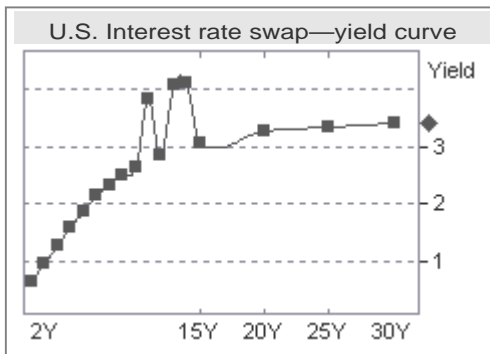
|         | SPREAD |        | RATE |      |
|---------|--------|--------|------|------|
| 2-Year  | 16.00  | 20.00  | 0.65 | 0.68 |
| 3-Year  | 18.50  | 22.50  | 0.96 | 0.98 |
| 5-Year  | 16.50  | 20.50  | 1.59 | 1.61 |
| 7-Year  | 5.25   | 9.25   | 2.13 | 2.14 |
| 10-Year | -4.25  | -0.25  | 2.62 | 2.62 |
| 30-Year | -39.75 | -35.75 | 3.39 | 3.38 |

FUTURES

|            | PRICE  | CHANGE |
|------------|--------|--------|
| CBOT 5 yr  | 120.76 | 0.37   |
| CBOT 10 yr | 125.47 | 0.53   |
| CBOT 30 yr | 133.00 | 0.91   |

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

|          | BID   | ASK   | BID   | ASK   |
|----------|-------|-------|-------|-------|
| O/N      | 0.200 | 0.230 | -     | -     |
| 1-Month  | 0.250 | 0.350 | 0.178 | 0.188 |
| 3-Month  | 0.300 | 0.420 | 0.180 | 0.190 |
| 6-Month  | 0.480 | 0.620 | 0.183 | 0.193 |
| 12-Month | 0.800 | 1.100 | 0.213 | 0.223 |



CURRENCIES

|             | BID     | ASK     |
|-------------|---------|---------|
| Euro        | 1.3019  | 1.3022  |
| Sterling    | 1.5561  | 1.5566  |
| JP Yen      | 83.10   | 83.12   |
| Swiss Franc | 0.9951  | 0.9954  |
| Can Dollar  | 1.0245  | 1.0250  |
| Mexico      | 12.8119 | 12.8220 |

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

|      |        |    |        |
|------|--------|----|--------|
| Open | 0.2100 | 1m | 0.2460 |
| High | 0.2700 | 3m | 0.3135 |
| Low  | 0.1400 |    |        |

ACTIVE FANNIE MAE AGENCIES

| TERM    | COUPN | MATURITY   | YIELD-SPREAD |      | YIELD |
|---------|-------|------------|--------------|------|-------|
| 2-Year  | 0.625 | 24/09/2012 | 14.5         | 13   | 0.64  |
| 3-Year  | 1     | 23/09/2013 | 20           | 19.5 | 0.97  |
| 5-Year  | 1.75  | 10/09/2015 | 28           | 27.5 | 1.71  |
| 7-Year  | 3.75  | 27/03/2019 | 6            | 5    | 2.72  |
| 10-Year | 6.625 | -          | 23           | -    | 4.02  |
| 30-Year | 6.25  | 15/07/2032 | 23           | -    | 4.02  |

ACTIVE FREDDIE MAC AGENCIES

| TERM    | COUPN | MATURITY   | YIELD-SPREAD |      | YIELD |
|---------|-------|------------|--------------|------|-------|
| 2-Year  | 1.125 | 27/07/2012 | 9.5          | 9    | 0.59  |
| 3-Year  | 0.875 | 28/10/2013 | 21           | 20.5 | 0.98  |
| 5-Year  | 2.375 | 28/07/2015 | 23.5         | 22.5 | 1.66  |
| 7-Year  | 5.125 | 18/10/2016 | 5            | 2.5  | 2.13  |
| 10-Year | -     | -          | -            | -    | -     |
| 30-Year | -     | -          | -            | -    | -     |

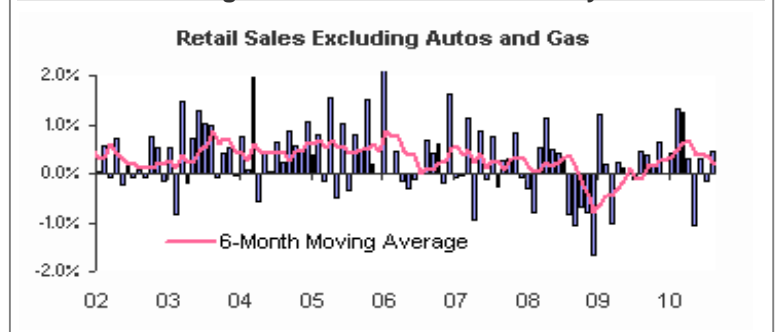
Active MBS 15YR

|       | CPN | BID      | ASK      | YIELD |
|-------|-----|----------|----------|-------|
| FNMA  | 4.0 | 104.2400 | 104.2400 | 2.435 |
| FHLMC | 4.0 | 104.2300 | 104.2300 | 2.484 |

Active MBS 30YR

|       | CPN | BID      | ASK      | YIELD |
|-------|-----|----------|----------|-------|
| FNMA  | 4.5 | 104.1220 | 104.1260 | 2.960 |
| FHLMC | 4.5 | 104.0900 | 104.0900 | 2.940 |
| GNMA  | 4.5 | 105.2110 | 105.2150 | 2.934 |

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



## TODAY'S TOP NEWS

**U.S. retail sales gain eases new recession fears**

Sales at U.S. retailers posted their largest gain in five months in August on strong receipts at gasoline stations and clothing outlets, further assuaging fears of a double-dip recession.

The Commerce Department said retail sales rose 0.4 percent, adding to data such as private payrolls and manufacturing for August that have pointed to a tentative improvement in the economy after a recent soft patch.

Sales were boosted by back-to-school buying and tax holidays in some states, with gains widespread across most categories. Auto sales, however, fell 0.7 percent.

Excluding autos, sales increased by a bigger-than-expected 0.6 percent, the largest increase since March. But some investors were skeptical consumers would continue to spend given a 9.6 percent unemployment rate and opted instead to buy U.S. government debt, pushing up their prices.

Business inventories increased 1 percent in July, the largest rise since July 2008 and double market expectations for a 0.5 percent gain. The report showed sales rebounding from a July. Core retail sales, which exclude autos, gasoline and building materials, rose 0.5 percent after dipping 0.1 percent in July.

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**AIG, U.S. repayment talks advancing -- source**

American International Group talks with the U.S. Treasury Department over the repayment of taxpayer funds have advanced past initial discussions, a source familiar with the matter said.

A possible conversion of the Treasury's \$49 billion preferred stake in AIG into common stock is one of the options being discussed, the source said, who declined to be named because the talks are not public.

AIG owes the Fed about \$21 billion under a credit facility. The Fed also owns \$25 billion worth of preferred interest in two of AIG's foreign life insurance units that must be monetized.

The company expects a big part of that money to come in by the end of the year, as it closes on the sale of American Life Insurance to MetLife for \$15.5 billion and lists AIA in Hong Kong.

The plan for the Treasury to exit AIG ownership could be rolled out as early as the first half of 2011, the Wall Street Journal reported. This move would increase the government's ownership stake in the insurance company to above 90 percent from 79.8 percent currently, the Journal said. Converting the Treasury's preferred stake into common shares has been seen as an option to end the government role in the insurer.

**S&P says Japan govt credit quality is "slowly sinking"**

Japan's credit quality is slowly sinking but not at an extent that could trigger an immediate downgrade, credit rating agency Standard and Poor's said.

Japan's outstanding public debt is the largest among industrial nations, approaching twice the size of its GDP, although most of it is held by domestic investors. Ogawa said Prime Minister Naoto Kan's win in a ruling party leadership race indicates a continuation of the government's fiscal and macroeconomic policies, which is not necessarily beneficial to ratings. Rival rating agency Fitch Ratings warned in July that a delay in a credible plan before year-end for fiscal consolidation would increase the risk of a rating downgrade.

Standard & Poor's has a negative outlook on Japan's rating which indicates the potential direction of the rating in the intermediate term which is typically six months to 2 years.

Fitch rates Japan's foreign currency debt AA and its local currency debt at AA-minus, with a stable outlook.

**Bill to aid small-business advances in U.S. Senate**

Democrats in the U.S. Senate advanced a measure to help small businesses, less than two months before they face voters who blame them for an economy still burdened with high unemployment.

The 61 to 37 vote enables Democrats to move toward a final vote on a long-stalled package of lending incentives and tax breaks for small businesses, possibly by the end of the week. The House of Representatives has already passed a similar version of the bill.

The bill represents one of the party's final chances before the Nov. 2 elections to show voters they are working to improve the economy. If the measure clears Congress, it would be a rare victory on the job-creation front for the Democrats, who have seen many of their other efforts blocked by Republicans this year.

Separately, Thirty-six U.S. farm and business groups urged Congress not to pass legislation threatening China with duties on some of its goods if Beijing does not revalue its currency.

"We strongly oppose legislation that would allow use of either the anti-dumping or countervailing duty law to address currency concerns for several years," said the group.

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**IMF head says Basel falls short on bank supervision**

The proposed Basel III bank capital rules go in the right direction but need to be completed by a strengthening of banking supervision, the head of the International Monetary Fund said.

"There was an absolute need to remodel the rules of the financial sector... this, at the moment, is much more important than potential negative effects on growth that could come from the increase in regulation," Dominique Strauss-Kahn said in an interview in Italy's Il Sole 24 Ore. But the IMF head said supervision is more important.

Separately, New capital rules are expected to increase loan prices for customers, JPMorgan Chase said in an investor presentation published on its website. JPMorgan is facing a wave of global and U.S. regulatory reforms that it expects will eat into its revenues even as it begins to recover from the financial crisis. The loan price increases, triggered by the so-called Basel III rules announced by global regulators on Sunday, will vary depending on the customer and the loan type, according to the presentation.

**Refunding risk diminishing for corporations-Moody's**

The risk of companies defaulting on maturing debt has receded but debt coming due after 2012 remains a risk if continued weakness in growth and the U.S. jobs picture linger, Moody's Investors Service said.

The rating agency said the amount of U.S. corporate bonds coming due in the next two-and-a-half years has fallen 22 percent, to roughly \$311 billion. "As the U.S. economy is slowly emerging from the Great Recession, investment-grade and speculative-grade companies have had an easier time refinancing their upcoming debt maturities," Moody's said. "Refunding risk, measured by market conditions and company specific ratings, has declined." Issuance has been particularly strong among speculative-grade issuers, which have benefited from yield-hungry investors, low interest rates, improving liquidity, and somewhat better economic conditions, Moody's said.

The \$550 billion of 2013 and 2014 speculative-grade debt maturities noted in a previous report are probably much lower now because of the robust debt issuance in the first half of 2010.

## TODAY'S TOP NEWS

**Obama edges toward decision on Warren as regulator**

Lawmakers pressed President Barack Obama to seek Senate confirmation for his new consumer financial regulator instead of making a temporary appointment as he edged toward naming Wall Street critic Elizabeth Warren to the post.

Obama is considering picking Warren to run the new consumer financial protection agency as interim chief, a move that would avoid a messy confirmation battle. The choice of Warren, which could be announced as early as this week, would set up a new fight with Republicans in the heat of the November congressional election campaign.

But Senate Banking Committee Chairman Christopher Dodd and moderate Republican Senator Olympia Snowe weighed in against any maneuver to avoid putting his nominee up for full Senate scrutiny.

Warren has bemoaned mortgages that are unsuitable for borrowers, the increase in the types of credit card fees, and confusing pay-day loans. If Obama decides to formally nominate Warren as the new director of the consumer bureau, she could serve for a term of up to five years.

**BoE's Weale eyes alternatives to QE to boost economy**

The BoE's may have to consider alternatives to quantitative easing that are closer to fiscal policy if the economy slows sharply, new policymaker Martin Weale told legislators.

Weale was more open than most other MPC members have been in conceding that the BoE could need to look for alternatives to simply buying more gilts with newly created money in the case of an unexpected downturn.

Quantitative easing had been less successful in boosting lending to small businesses than might have been hoped, due to the failure of an increased money supply in the hands of banks to translate into more available credit, Weale said.

Meanwhile, UK consumer price inflation held steady at 3.1 percent last month, more than a percentage point above target. The core rate of inflation rose to 2.8 percent from July's 2.6 percent. CPI inflation jumped by 0.5 percent, compared to a 0.2 percent fall in July.

**Weakening euro zone output points to slowing growth**

Euro zone monthly industrial production was weaker than expected in July, pulled down by a slump in durable consumer goods, and pointing to slowing economic growth in the second half of the year.

Eurostat said industrial production was flat month-on-month for a 7.1 percent year-on-year rise. It also revised down its June production figures to -0.2 percent month-on-month from -0.1 percent.

Separately, Germany will rein in its net new borrowing this year, the finance minister said, vowing to consolidate public finances amid a downturn from which he said he expected a steady but slower recovery next year. Finance Minister Wolfgang Schaeuble said Germany's net new borrowing in 2010 will be somewhere between 50 and 60 billion euros.

Also, German investor morale fell to its lowest since February 2009 in September, and the finance minister said growth in Europe's largest economy would slow down next year. ZEW think tank said its monthly poll of economic sentiment fell to -4.3 in September from 14.0 in August.

**New figures show patchy Canadian economic recovery**

In another signal of a patchy economic recovery in Canada, industrial capacity use rose in the second quarter of 2010 -- the fourth consecutive increase -- but remained well below recent peaks.

Statistics Canada said that industries operated at 76.0 percent of total capacity, up from the revised 74.4 percent in the first quarter, and slightly higher than the 75.8 percent expected by market operators.

Separately, Statscan said labor productivity dropped by a greater-than-expected 0.8 percent in the second quarter.

Meanwhile, the BoC is taking into account the lessons of the financial crisis in preparing to decide, with the Canadian government, on its next mandate. There is considerable uncertainty surrounding Canada's economic outlook and its central bank will consider this in setting monetary policy, BoC Governor Mark Carney said.

## NEXT UP

**Investors more bullish on U.S. Treasuries - poll**

Investors turned more bullish on the outlook for U.S. Treasuries in recent days following a price sell-off late last week prompted in part by heavy government and corporate debt supply, a poll released showed.

The share of investors who said they are "long," or owning more Treasuries than their portfolio benchmarks, rose to 33 percent on Monday from 24 percent last week, J.P. Morgan Securities said. This level of investor optimism on Treasuries was the highest since Oct. 13, 2009, the firm said.

Indeed, Treasuries rose for the second consecutive day in continued bargain hunting after benchmark notes last week logged their weakest weekly performance since March.

Diminished corporate debt supply, along with a lack of new government debt supply this week and the Federal Reserve itself purchasing Treasuries offered price support early this week.

"This week gives us two Fed buybacks and no supply, which perhaps provides the breathing space Treasuries need to recoup some of last week's sharp losses after long-end duration hit the market," said George Goncalves, head of U.S. interest rates strategy at Nomura Securities International in New York.

**Investors' cash overweight hits 1-year high - BofA**

Investors boosted their overweight cash positions to the highest level in more than a year in September as economic uncertainty and low risk appetite encouraged them to seek safety, a survey showed.

The monthly fund managers' survey from BofA Merrill Lynch showed investors added bonds even though they viewed the asset class as the most expensive relative to equities since the record began in early 2003.

According to the poll, which surveyed 215 managers who manage total assets of \$579 billion, their cash balance rose to 4 percent from 3.8 percent, leaving their overweight cash positions at 20 percent from 10 percent last month. Investors' net equity overweight position fell to 10 this month from 12 percent in August -- well below the April high of 52 percent. This means the difference between overweights and underweights is 10 percentage points. "Investors are coming back from summer holidays feeling grumpy. Risk appetite is low and growth expectations are subdued. There is greater index hugging going on given the lack of conviction," said Gary Baker, European equity strategist at BofA Merrill Lynch.



## DEEP DIVE Commentary and Analysis

## Fed debate on more easing to heat up

By Kristina Cooke and Mark Felsenthal

Fundamental differences among U.S. central bankers about how bad the economic outlook is set the stage for a heated debate next week about the need for more monetary easing and how to do it.

Federal Reserve officials gather on Sept. 21 for the first time since their controversial decision last month to buy more bonds to keep the credit they are providing the economy steady -- a move many analysts saw as a shift toward more support.

Recent data, including a better-than-expected jobs report, takes some pressure off the Fed. It also makes a decision to embark on further efforts to boost the sluggish recovery, most likely through larger-scale bond buying, unlikely next week.

"Like a lot of people I think the big decision whether to do something ... will be at future meetings," said Lou Crandall, chief economist with Wrightson ICAP in Jersey City, New Jersey.

Fed Chairman Ben Bernanke said in late August that it would take a significant deterioration of the economic outlook to warrant more easing.

Yet six of 15 economists at banks that do business directly with the Fed said in a Reuters poll earlier this month that they expect another round of so-called quantitative easing to start before year-end.

Also, some at the Fed may have a lower threshold for further action.

Donald Kohn, who stepped down as a Fed governor on Sept. 1, said he would want to make sure the economy was on track to pull down the jobless rate and move inflation a bit higher.

"To not trigger something, I would want to see that there was the prospect of progress in the forecast," he told the New York Times a few days after he retired.

But even if Fed officials could agree on what might warrant further easing -- a risk of deflation or further weakening of the jobs market -- they would likely still diverge on when a triggering level had been hit.

Officials disagree, for example, on the risk of a dangerous downward spiral in prices. Philadelphia Federal Reserve Bank President Charles Plosser, for one, currently sees no deflation risk, while St. Louis Fed chief James Bullard has warned that deflation risks have risen.

## IS SHOCK AND AWE SO 2008?

If the Fed decides the sputtering economy needs more help, the most likely tool it would reach for would be further purchases of longer-term securities. But it would probably pursue a different path than it did the first time around.

After pushing overnight interest rates close to zero in December 2008, the Fed bought \$1.25 trillion worth of mortgage-backed securities, \$175 billion in mortgage-agency debt and \$300 billion of longer-term Treasuries.

This time, it would likely concentrate primarily on Treasuries, since it owns so much mortgage-related debt already. Officials have worried that buying mortgage-linked debt distorts housing markets and have pushed to restore the predominance of Treasuries in the Fed's portfolio.

Policymakers would then have to decide whether to announce that they are ready to buy an eye-popping amount of securities to achieve maximum effect, or go gradually, calibrating purchases to the evolving economic outlook.

Bullard has advocated having the Fed decide at each meeting how much to buy so it could base its decision on how the economy is evolving.

"I don't think it's a good policy to do some kind of 'shock and awe,'" Bullard, a voter on the Fed's policy-setting panel this

year, told CNBC last week.

Goldman Sachs economist Sven Jari Stehn wrote in a note to clients that a gradual approach would allow the Fed to retain more flexibility, but at a cost of "foregoing some of the up-front boost to financial conditions that a 'big bang' announcement could deliver."

## A LOT TO GET A LITTLE

Stehn and others have argued that it takes huge purchases to move interest rates. The Fed's almost \$1.7 trillion worth of securities purchases lowered 10-year Treasury yields by about half a percentage point, Fed and other analysts have said.

If, as forecasting firm Macroeconomic Advisors estimates, each \$100 billion in asset buys lowers yields on the 10-year Treasury note by 0.03 percentage points, gradual buying might go unnoticed.

"That might actually be counterproductive because people might start thinking the Fed is powerless, if they see new purchases having little effect," said Macroeconomic Advisors economist Antulio Bomfim.

A hybrid approach -- announcing purchases up to a certain large amount with the caveat that buying will depend on evolving economic conditions -- might be the best way to go, Bomfim said.

Finally, there is debate about the efficacy of securities buying and discussion of alternatives.

Bernanke outlined some of the alternatives in a speech this summer, including lowering the rate on excess reserves banks hold at the Fed and promising to hold interest rates at rock-bottom levels for even longer than markets have already priced in.

Bernanke offered a wider array of choices in a 2002 speech when he was a Fed governor, suggesting targeting specific interest rates and offering banks low or zero interest loans against collateral as a way to combat deflation risks. Those are all ideas that could come up for debate again at the central bank next week.

## U.S. banks feeling pressure at the margin

By Joe Rauch

U.S. banks could soon start to feel the pain of zero interest rates.

In recent months, the longer-term rates at which banks lend have fallen fast. But the short-term rates at which banks fund their operations cannot get any lower than zero. The net effect is likely going to be shrinking profit margins on loans and possibly less income overall for the sector, analysts said.

"Banks are in the same dilemma as investors," said Jeff Davis, a bank analyst with Guggenheim Partners. "Where do you put your money to get some return without taking on what you think is out-sized risk?"

Weaker income is a big blow for a sector still reeling from the subprime housing collapse and credit crunch that started in 2007 and began abating in 2009.

Even as credit losses were soaring during the crisis, banks' interest income was a bright spot. With short-term rates at essentially zero, banks have enjoyed cheap funding costs since 2008, allowing for surprisingly strong profit margins on loans.

In the first half of 2010, U.S. banks' net interest margin reached 3.81 percent, its highest point since 3.96 percent in 2002, according to FDIC data.

Wide margins have given banks more lending income before credit losses: Net interest income at U.S. lenders increased 9.1 percent in the first half of 2010 to \$216 billion, from \$198 billion in the first half of 2009.



## DEEP DIVE Commentary and Analysis

In 2008, interest income was \$191 billion.

Some banks are using derivatives such as interest-rate floors that can allow them to maintain their profit margins.

Consider Winston-Salem, North Carolina-based regional bank BB&T Corp, which cites derivatives as a reason for the bank's net interest margin to remain stable in coming quarters.

"As long as we can continue to put floors on these loans, we think that a Japan-type economic scenario will shrink the market, but won't materially affect our margin," BB&T Chief Financial Officer Daryl Bible said in an interview.

The bank, Bible said, is projecting for its net interest margin, now at 4.12 percent, to fluctuate only 0.03 percent in coming quarters.

But hedging interest-rate movements can be tricky and expensive, particularly if rates move in directions not hedged for. Not every bank can successfully execute that strategy.

## FIERCE COMPETITION

At least two factors are likely pressuring what banks can charge on loans right now, analysts said. One is the low level of longer-term Treasury yields, which indirectly pulls down most rates on new longer-term loans in the United States.

The second is that the United States has about 8,000 banks that are struggling to boost their loan books when demand for loans

is weak.

"Its going to be extremely fierce competition for loan growth," Bob Patten, a bank analyst with Morgan Keegan & Co said, noting the top 50 U.S. banks' net interest margin contracted in second quarter 0.06 percent, after growing for the previous six quarters.

The Federal Reserve's July senior loan officer survey found most banks were loosening lending standards amid stagnant demand from consumer and corporate customers.

And individual banks are reporting data that seems to match those survey results. Regions Financial Corp's Chief Executive Grayson Hall told investors on Thursday that commercial credit line usage remains at near historic lows, with borrowers using roughly 40 percent of their available credit lines.

That figure, he said, has not moved in months, and the bank is focusing on bringing in new clients, requiring Regions' bankers to call on 18,000 client prospects each month.

Net interest margins, and overall interest income, means more to some banks than others, but most U.S. lenders rely heavily on interest income for overall profit. Weak loan demand is not a good thing, analysts said.

"This is a Catch 22 for banks," said Michael Nix, principal at Greenwood Capital Associates. "Until banks really start lending again, their margins are going to be constrained."

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