

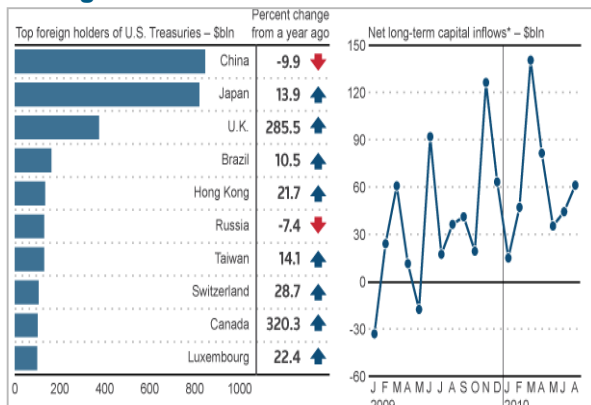
INSIDE DEBT

PRODUCED BY REUTERS IN PARTNERSHIP WITH ICAP

Thursday, September 16, 2010

CHART OF THE DAY

Foreign holders of U.S. Treasuries



While eight of the top ten foreign holders of Treasuries increased their holdings in August, China, the largest holder has pulled back nearly 10 percent.

TODAY'S TOP NEWS

- U.S. jobless claims at two-month low, PPI rises
- Geithner vows to take China currency dispute to G20
- SEC to crack down on banks' debt disclosures
- Japan PM: ready to step into forex markets again
- CFTC outlines number of new swaps dealers, venues
- Obama hopes to move forward on trade pacts
- Obama welcomes passage of small business bill

ECON WATCH

FOR FRIDAY SEPTEMBER 17

ET	Indicators	Unit	Reuters	Prior
02:00 DE	Producer prices mm	%	0.2	0.5
02:00 DE	Producer prices yy	%	3.5	3.7
04:00 EZ	Current account nsa	bln	-	1.0
04:00 EZ	Current account sa	bln	-	-4.6
08:30 US	Consumer prices mm	%	0.2	0.3
08:30 US	Consumer prices yy	%	1.1	1.2
08:30 US	Ex-food/energy mm	%	0.1	0.1
08:30 US	Ex-food/energy yy	%	1.0	0.9
08:30 US	CPI index level	ind	218.3	218.0
08:30 US	Real earnings	%	0.1	0.2
09:55 US	Reuters/U.Mich senti	ind	70.0	68.9
09:55 US	Current conditions	ind	79.0	78.3
09:55 US	Expectations	ind	64.2	62.9

MARKETS TODAY

TODAY'S TOP STORY: New U.S. claims for jobless benefits hit a two-month low last week, hinting at some stability in the labor market, while the contraction in factory activity in the Mid-Atlantic region eased in September. **For more please click here**

TREASURIES: Treasury prices fell after mildly reassuring data reduced expectations the Federal Reserve would renew quantitative easing in the form of massive debt purchases aimed at jump-starting the economy.

- 30-yr bonds fell 27/32 to yield 3.92 from 3.87 on Wednesday.
- 10-yr notes lost 11/32 yielding 2.76, while 2-yr notes remained unchanged at 0.48.
- 5-yr notes shed 3/32 to yield 1.47 pct.
- 2-30's part of the yield curve steepened by 5 bps to 345 bps.

FOREX: The yen was little changed against the U.S. dollar with the Bank of Japan silent after massive yen-selling in the prior session and investors reluctant to place bets in case the central bank begins new sales to weaken the currency.

- Dollar rose 0.09 pct to 85.82 yen, earlier hit a session high of 85.84 yen on electronic trading platform.
- The euro rallied 0.51 pct to \$1.3079 after rising to \$1.3117, its highest since Aug. It rose 0.61 pct to 112.23 yen.
- Dollar gained 1.22 pct to 1.0147 francs. Euro jumped 1.69 pct to 1.3271 francs, the biggest daily rise since May 19.
- The dollar index fell 0.28 pct to 81.264. Sterling rose 0.02 pct to \$1.5629.

CORPORATES: Corporate bond spreads held steady, as investor demand for new debt sales remained robust and economic data suggested the economy was continuing to grow, albeit slowly.

- The CDX.IG-14 index was unchanged at 104 bps.
- Demand for a stream of new bond issues remains brisk, with more than \$24 billion in Investment grade corporate debt sold so far this week.
- Transocean launched a \$2.0 bln, two-part note sale while Nucor Corp sold \$600 mln of senior unsecured notes.

STOCKS: Stocks were little changed as mixed economic data and a cautious forecast from economic bellwether FedEx Corp kept the market locked in its recent tight trading range.

- Dow rose 0.21 pct to 10,595.21, S&P fell 0.03 pct, to 1,124.74 and Nasdaq gained 0.08 pct to 2,303.25.
- FedEx fell 3.75 pct to \$82.72 while UPS fell 1.37 pct to \$66.73, and the S&P air freight logistics index dropped 1.84 pct.
- Ford rose 4.8 pct to \$12.44 and RIM's U.S.-traded shares rose 2.13 pct.
- S&P auto index rose 3.98 pct while S&P energy fell 0.36 pct.

C & E: Oil prices fell nearly 2 percent, sliding for a third day, as U.S. Mid-west supply anxieties eased further on news that a major Canadian pipeline carrying crude to the region would be back in service by Friday.

- U.S. Crude oil fell 2.08 pct to \$74.44 per barrel.
- Gold rose 0.72 pct to 1,274.8 an ounce.
- Reuters-Jefferies index shed 0.13 pct to 278.69.

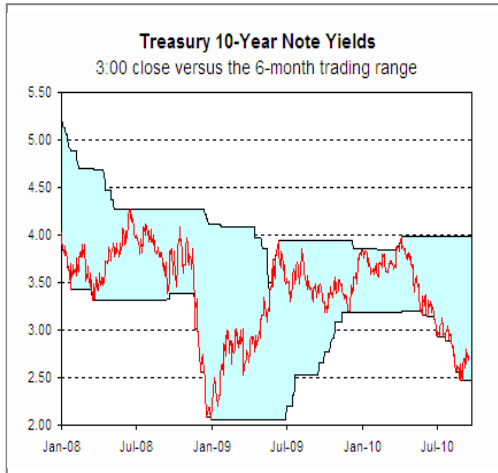
INTRODUCING THOMSON REUTERS EIKON

THOMSON REUTERS EIKON  [CLICK TO SEE THE DEMO](#)

- 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	0.130	0.095	0.132	0.006
3-Mo Bill	0.155	0.145	0.157	-0.003
6-Mo Bill	0.190	0.185	0.193	-
1-Year	0.245	0.220	0.249	0.002
2-Year	99.781	99.813	0.488	0.008
3-Year	99.938	99.969	0.772	0.000
5-Year	98.961	99.008	1.469	-0.070
7-Year	98.219	98.266	2.152	-0.188
10-Year	98.797	98.859	2.764	-0.313
30-Year	99.125	99.203	3.925	-0.875

EQUITIES

	INDEX	CHANGE
DJIA	10580.95	8.22
NASDAQ	2298.52	-2.80
S&P 500	1122.65	-2.42

OIL

	PRICE	CHANGE
NYMEX	74.5	-1.5
BRENT	79.2	1.0

EURODOLLAR FUTURES

	CLOSE	CHANGE
Oct-10	99.678	0.005
Dec-10	99.610	0.010
Mar-11	99.545	0.010
Jun-11	99.450	0.005

REPURCHASE AGREEMENTS

G/C		MORTGAGE REPOS	
O/N	0.360	O/N	0.360
2-Week	0.290	2-Week	0.320
1-Month	0.290	1-Month	0.320
3-Month	0.300	3-Month	0.310
AGENCY REPOS		i-REPO SM INDEX	
O/N	0.360	10:00 AM	0.300
2-Week	0.320	3:00 PM	0.316
1-Month	0.300		
3-Month	0.300		

IR SWAPS <19901>

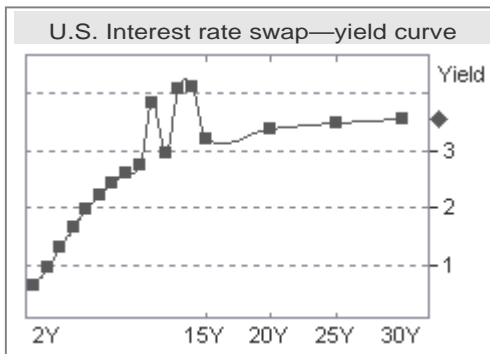
	SPREAD		RATE	
2-Year	17.75	21.75	0.65	0.68
3-Year	21.00	25.00	0.98	1.00
5-Year	20.25	24.25	1.66	1.68
7-Year	8.00	12.00	2.23	2.24
10-Year	-1.00	3.00	2.75	2.75
30-Year	-37.50	-33.50	3.55	3.54

FUTURES

	PRICE	CHANGE
CBOT 5 yr	120.16	0.15
CBOT 10 yr	124.61	0.19
CBOT 30 yr	131.63	0.09

EURODOLLAR DEPOSITS & OIS STRIPS (ASKED)

	BID	ASK	BID	ASK
O/N	0.220	0.260	-	-
1-Month	0.250	0.350	0.182	0.192
3-Month	0.300	0.420	0.182	0.192
6-Month	0.480	0.620	0.184	0.194
12-Month	0.760	1.050	0.212	0.222



CURRENCIES

	BID	ASK
Euro	1.3082	1.3084
Sterling	1.5634	1.5638
JP Yen	85.78	85.80
Swiss Franc	1.0148	1.0152
Can Dollar	1.0263	1.0268
Mexico	12.8279	12.8380

FED FUNDS NYFRSM - 10AM

Open	0.2200	1m	0.2501
High	0.2800	3m	0.3113
Low	0.1500		

ACTIVE FANNIE MAE AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	0.625	20120924	12	11.5	0.6
3-Year	1	20130923	22	21	0.99
5-Year	1.75	20150910	29	28.5	1.75
7-Year	3.75	20190327	9	5	2.85
10-Year	-	-	-	-	-
30-Year	6.25	20320715	26	21	4.18

ACTIVE FREDDIE MAC AGENCIES

TERM	COUPN	MATURITY	YIELD-SPREAD		YIELD
2-Year	1.125	20120727	10	-	0.58
3-Year	0.875	20131028	22	20.75	0.99
5-Year	2.375	20150728	26	25	1.72
7-Year	5.125	20161018	7	-	2.22
10-Year	6.625	20301115	23	20	4.15
30-Year	-	-	-	-	-

Active MBS 15YR

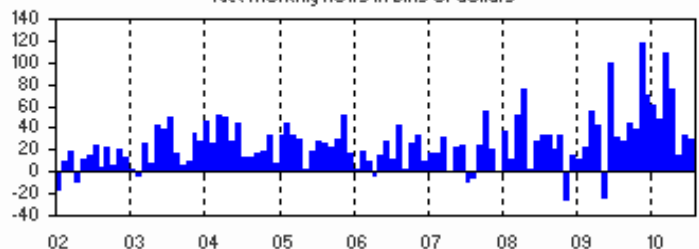
	CPN	BID	ASK	YIELD
FNMA	4.0	104.0970	104.1030	2.571
FHLMC	4.0	104.0970	104.1030	2.607

Active MBS 30YR

	CPN	BID	ASK	YIELD
FNMA	4.5	104.0270	104.0330	3.055
FHLMC	4.5	103.2660	103.2720	3.089
GNMA	4.5	105.0860	105.0920	3.033

Wrightson ICAPSM Chart of the Day

Net Foreign Purchases of Long-Term U.S. Treasuries
Net monthly flows in blns of dollars



TODAY'S TOP NEWS

U.S. jobless claims at two-month low, PPI rises

New U.S. claims for jobless benefits hit a two-month low last week, hinting at some stability in the labor market, while the contraction in factory activity in the Mid-Atlantic region eased in September.

Initial claims for state unemployment benefits slipped 3,000 to 450,000, the lowest since early July, the Labor Department said. Separately, the Philadelphia Federal Reserve Bank said its business activity index covering the mid-Atlantic moved to minus 0.7 in September from minus 7.7 in August. Markets had expected a reading of 2.0.

Prices paid by producers at the farm and factory gate were pushed up by the first increase in energy costs since March. Markets had expected the PPI to rise 0.3 percent after July's 0.2 percent gain.

Meanwhile, Foreigners resumed purchases of U.S. securities in July, reversing the prior month's net outflow, and China and Japan both added to holdings of U.S. government debt, the U.S. Treasury Department said.

Overseas investors bought a net \$63.7 billion, including short-term instruments such as Treasury bills. That reversed a revised net outflow of \$5.2 billion in June. Net long-term capital inflows rose to \$61.2 billion from \$44.4 billion. China, the biggest holder of U.S. Treasury debt, increased its holdings by \$3 billion to \$846.7 billion.

SEC to crack down on banks' debt disclosures

Federal regulators are trying to improve debt disclosures in an effort to crack down on financial firms that use accounting gimmicks to bolster their balance sheets.

The SEC meets on Friday to consider a proposal that would require companies to disclose more information about its short-term borrowings.

The SEC's action comes after it reviewed accounting and disclosure data from 19 of the largest financial companies.

The regulator did not find that the companies improperly used accounting tricks such as the so-called "Repo 105" method that Lehman Brothers was said to have used to conceal losses.

A court examiner's report, issued earlier this year, found Lehman did about \$50 billion in Repo 105 transactions, in which repurchase deals were booked as sales instead of financings. That accounting move allowed Lehman to conceal assets and liabilities, according to the report.

CFTC outlines number of new swaps dealers, venues

More than 200 entities could look to become swap dealers, including global and regional banks that offer swaps in the United States, the head of the CFTC said as the agency ramps up oversight of derivatives trading.

CFTC Chairman Gary Gensler broadly outlined for the first time how many groups could be impacted by the new rules for the giant over-the-counter market, enacted as part of the recently passed Dodd-Frank financial reform bill. Gensler, also estimated about 20 to 30 new entities will register as SEFs or designated contract markets. The legislation, meant to avoid a repeat of the 2007-2009 financial crisis, requires standardized swaps to trade on exchanges or SEFs, and saddles banks and other swaps dealers with additional regulations. "This is a real change in the marketplace. I don't think anybody should think that it is not," Gensler said. "Initial estimates are that there could be in excess of 200 entities that will seek to register as swap dealers," he said, adding later he wanted to give observers -- keenly interested in which dealers will be eligible -- a preliminary target.

Geithner vows to take China currency dispute to G20

U.S. Treasury Secretary Timothy Geithner vowed to rally other world powers to push China for trade and currency reforms as he was grilled by lawmakers demanding a crackdown on Beijing's policies.

China warned that pressure from Washington could backfire. Raising the stakes as part of a tougher line on China's policies, Geithner said the United States would use a Group of 20 summit in Seoul in November to try to mobilize trading partners to get Beijing to let the yuan strengthen faster.

Geithner's threat to make China's currency system a focal point of the G20 summit could buy time to show that President Barack Obama's administration is serious about his pledge to use "all tools available" to remedy the situation.

Geithner said the yuan was strengthening too slowly and the Obama administration was looking for ways to get Beijing to move faster.

Insisting that China's currency practices were hindering the U.S. economic recovery, lawmakers pressed Geithner to declare China a "currency manipulator" when the Treasury Department's next foreign exchange report is due on Oct. 15.

But Geithner cast doubt on the effectiveness of such a move, saying it would not guarantee concrete results. Senate Banking Committee Chairman Christopher Dodd told Geithner the time for action was "long overdue."

Japan PM says ready to step into forex markets again

Japan's prime minister signaled that authorities would keep intervening to curb yen strength as sagging manufacturing confidence underscored the threat the currency poses to the fragile economic recovery.

A Reuters monthly poll that tracks the BOJ tankan report showed manufacturing confidence dropped in September from August for the first time in nearly a year as firms struggled with the yen's rise to a 15-year high against the dollar.

BoJ money market data showed the yen-selling may have totaled up to 1.86 trillion yen (\$21.7 billion), which would be a record for a single day.

Kan wants to be proactive in tackling the yen after winning the ruling party leadership race on Tuesday. He is expected to reshuffle his cabinet soon but retain Yoshihiko Noda as finance minister.

Obama hopes to move forward on trade pacts

President Barack Obama said he wants to advance free trade agreements with U.S. partners, including important ally South Korea, and repeated a vow to double America's exports over the next five years.

The president is seeking to augment weak domestic demand by boosting sales abroad as he fights unemployment near 10 percent and flagging economic growth. But he also wants trade pacts to include standards protecting worker rights and the environment.

Top White House adviser Larry Summers later said the United States would have little chance of curbing unemployment if it failed to approach Obama's goal on exports.

Commerce Secretary Gary Locke later reiterated that the president supported moving forward on deals with these countries, but stressed that more work was needed.

Obama wants to resolve concerns over a trade pact with South Korea by November -- when he will visit the country to attend a Group of 20 leaders summit -- so he can submit the agreement to Congress by early next year.



TODAY'S TOP NEWS

Obama welcomes passage of small business bill

President Barack Obama welcomed the U.S. Senate's passage of a long-stalled measure that would boost lending to small businesses, saying it would help create jobs.

Separately, U.S. Senate Democrats rejected a bill to make a business research tax credit permanent after Republicans tried to attach it to a long-stalled small-business bill.

Democrats rejected the research and development tax credit on the grounds that it would delay passage of a larger small-business bill, which President Barack Obama is pushing for as part of his efforts to jump-start the economy.

Democrats argued that attaching the R&D measure would cause further delays by forcing it back to the committee level.

Most Republicans oppose the small business measure, calling it a bailout because it includes a \$30 billion lending fund.

Republicans have blocked most of the Democrats' job creation bills this year and Democrats are eager to pass the measure before facing voters in November.

Bailout anger may hamper U.S. in future crisis-panel

Public anger over the U.S. Treasury's \$700 billion bailout program may hamper the government's ability to respond to a future financial crisis, a government watchdog warned.

The Congressional Oversight Panel said in its latest monthly report that the public "stigma" surrounding the TARP has constrained policy choices and may make it politically impossible to take similar rescue actions in the future.

The report concluded that TARP provided critical support at a time when the financial system was in "freefall," but created significant moral hazard in the financial system.

The latest report also concluded that Treasury Secretary Timothy Geithner's decision to extend TARP until Oct. 3 of this year did little other than to keep alive the government's implicit guarantee of the financial system.

Separately, GM is determined to pay back taxpayers as quickly as possible, but the process could take "several years," GM Chief Executive Dan Akerson.

Banks take over record number of U.S. homes in August

A record number of U.S. homeowners lost houses to their banks in August as lenders worked through the backlog of distressed mortgages, real estate data company RealtyTrac said.

RealtyTrac sees a record 1.2 million repossessions this year, up from just under 1 million last year, with more than 3.2 million homes in some stage of foreclosure. Banks foreclosed on 95,364 properties in August, topping the May 2010 record by 2 percent. 96,469 homes got a default notice. Defaults declined 1 percent from July and 30 percent from August 2009 after peaking at 142,064 properties in April 2009.

Separately, U.S. 30-year mortgage rates rose for a second straight week while those on 15-year mortgages dropped to a record low, according to a survey released by Freddie Mac.

Interest rates on U.S. 30-year fixed-rate mortgages averaged 4.37 percent for the week ended Sept. 16, up from the previous week's 4.35 percent, according to the survey.

Also, Fannie Mae said its latest nationwide survey showed that most Americans believed the housing market had reached bottom, yet they are more cautious about owning a home.

Euro zone July trade in surplus but exports slow

The euro zone posted a bigger-than-expected annual trade surplus in July, data showed, but slower growth in exports and imports reinforced expectations the economy will lose some momentum in the second half of the year.

The trade surplus of the 16 countries using the euro was 6.7 billion euros in July, Eurostat said. On a seasonally adjusted month-on-month basis the euro zone posted a trade deficit of 200 million euros in July as exports dipped 0.6 percent seasonally adjusted from June and imports fell 1.5 percent.

Meanwhile, German joblessness will likely fall below the key 3 million mark this year and employment will reach its highest level since reunification in 1990, fuelling the recovery, German officials said. The Federal Labor Office's research institute IAB said unemployment would fall to 2.958 million on average in 2011. Joblessness last dropped below the key psychological level of 3 million on an annual average basis in 1992.

NEXT UP

**U.S. TREASURY OUTLOOK
CPI, consumer sentiment**

Consumer sentiment and consumer prices headline economic data the U.S. government securities market will assess on Friday, even as attention shifts to next week's Federal Reserve policy meeting and the outlook for further monetary easing.

Bond investors still take an interest in the inflation indexes, but mainly to see that disinflation has not transitioned into outright deflation.

The more price indexes flirt with deflation, the more likely it is that the Fed would become more accommodative.

The consumer price index is expected to show prices rose 0.2 percent in August after a 0.3 percent July increase.

Consumer prices excluding food and energy items are expected to show a slight 0.1 percent rise in August after a 0.1 percent July increase, leaving the annualized rise at 1.0 percent.

Another report is expected to show August real earnings rose 0.1 percent after a 0.2 percent July increase.

Bond investors will also pay attention to the Reuters/University of Michigan consumer sentiment report. The preliminary index for September is expected to show a slight improvement in sentiment with a reading of 70.0, up from 68.9 in August.

Both the current conditions and expectations indices are expected to show modest gains to 79.0 and 64.2, respectively.

For bond investors, the crucial question is whether the discussion at the Federal Open Market Committee seems to leave policymakers closer to a second round of quantitative easing.

The Fed has already cut benchmark interest rates to near zero and put more than \$1.7 trillion into the economy through purchases of Treasury and mortgage-related debt. Any further easing would likely consist of more large-scale Treasury bond purchases, analysts said.

Lower 2011 growth forecasts and an intractable unemployment rate are both factors that could push the Fed toward further easing. A more widespread fear of deflation could also prompt the Fed to take fresh easing measures.



DEEP DIVE Commentary and Analysis

Speculators, China win big on yen move

By Jim Saft

What does \$4 trillion a day in business, never sleeps and sees Japan's Ministry of Finance as just one more patsy?

The foreign exchange market, of course, which is licking its collective lips as Japan embarks on another round of unilateral intervention to sell the yen in an effort to drive down its value and protect its export-oriented economy.

There are going to be two big winners in this, and neither begins with a "J."

Speculators will, as ever, benefit from having a deep-pocketed trading partner who has been so kind as to draw a bull's-eye on his own forehead and tell everyone at what level he will act. For Japan, that level appears to be just below 83 yen to the dollar and the Ministry of Finance has already spent \$20 billion moving it back to above 85 to the dollar.

Not a bad first day's effort but let us recall that the last time Japan decided to mess around in currency markets without international support it ended up spending well over \$300 billion between 2003-2004, a period when the yen actually appreciated by more than 13 percent.

Switzerland engaged in a similarly painful exercise in driving down the value of its franc earlier this year, shelling out something on the order of \$210 billion but seeing the currency actually increase in value against the euro, its main trading partner, by about 14 percent.

About the only thing that can be said in favor of Japan's action is that the Bank of Japan will not act to neutralize the effect of the intervention on the money supply, unlike in previous interventions. This will increase liquidity and should be inflationary, a welcome effect in the land of falling prices.

As for international success, so far the signs are not promising: "Unilateral actions are not the appropriate way to deal with global imbalances," Jean-Claude Juncker, chairman of the Eurogroup of euro zone finance ministers, said.

Even more astounding, a European Union source told Reuters that Japan had not even told the Europeans, much less the United States, about its plans to intervene.

There is an excellent reason for that: Japan had no hope in heaven that calls for a coordinated intervention would meet with anything but refusal. Quite the opposite, both the United States and Europe would doubtless like nothing better than for their own currencies to fall in value, thus supporting their own struggling economies. Do you think Greece wants a weaker yen? What about Michigan?

CHINA PLAYS A BEAUTY

The fact is that unilateral currency intervention in the current circumstances is nothing less than a tactic of a trade war, in deed if not in name.

So who is the other big winner in Japan's latest escapade? None other than China, which by buying Japanese debt has helped to precipitate the rise in the yen and now sees Japan do its dollar buying for it. Brilliant.

University of Oregon economist and noted Federal Reserve watcher Tim Duy presciently wrote about this possibility in August:

"Japanese intervention, if it occurs, means that Chinese authorities managed to get Japan to acquire their dollar reserves for them. Instead of buying dollars, China buys yen, which in turn induces Japan to buy dollars. This maintains the artificial capital flows to the U.S. while allowing China to escape accusations of being a "currency manipulator".

You do have to have sympathy for the Japanese authorities: they face deflation, a weak economy and political ructions at

home. What's more, they must see the possibility for further quantitative easing in the United States and realize that this will only strengthen the yen further.

Being expected to pay the price for China's reserve diversification must have been the last straw.

While China has done well on its own account, its actions have greatly increased the chances of protectionism and trade wars, or rather the chances that its own unilateral trade war will become generalized. The yuan has barely strengthened against the dollar since the much vaunted liberalization in June.

Sooner or later this must become intolerable to the U.S. administration, which is sailing into an election with high unemployment and a low approval rating. It should come as little surprise that the United States moved on Wednesday to bring two new cases against China before the World Trade Organization, one on steel and the other in banking.

As the year winds down, expect more of the same, and for it to be bad for growth and for stocks.

Until then, drinks are on the foreign exchange desks and the speculators.

(James Saft is a Reuters columnist. The opinions expressed are his own. At the time of publication James Saft did not own any direct investments in securities mentioned in this article. He may be an owner indirectly as an investor in a fund.)

To beat inflation or deflation, investors seek gold

By Amanda Cooper

Fear of inflation has always been one of the prime reasons for investing in gold, yet in an era of nail-biting uncertainty, investors are buying the shiny stuff to ward against price swings in either direction.

This was to be the year when the world economy flourished after suffering recession in 2009, corporate profits would bloom and central banks would remove their policy safety nets.

Investors would be ready to assume more risk, leaving their well-worn security blankets like gold to gather dust.

Things could not be more different. The Federal Reserve is widely expected to keep U.S. monetary policy loose as the economy struggles, global stocks are still a good 30 percent off pre-crisis highs and analysts are likely to trim their 2011 earnings forecasts, at least in Europe.

Market gauges of inflation expectations show little more than a muted rise in price pressures, but the more wary investors are taking no chances, and their hunt for safety has driven gold to new record highs this week above \$1,270 an ounce.

"Forgetting the present, generically speaking, gold is a hedge against inflation. In normal times, it would not be a hedge against deflation ... but because this time the association with deflation is panic, then that flight to quality and liquidity is worth something," said Charlie Morris, head of the HSBC Asset Management Absolute Return Fund.

"Given value credentials of gold, it would survive the current era of inflation and win mandates on the quality angle as opposed to anything else."

THEORY AND PRACTICE

Theory dictates the value of gold rises as other prices rise, unlike the value of a currency, which is eroded by inflation, leaving long-term investments such as government bonds at the mercy of the swings in consumer price indexes.

In nominal terms, the price of gold has more than tripled in the last 20 years, to around \$1,270 an ounce, from roughly \$400 an ounce in 1990. Adjusted for inflation however, the price has risen by some 70 percent in that time, so in 1990's money, to-



DEEP DIVE Commentary and Analysis

day's gold price is only worth about \$700.

Europe's sovereign debt crisis has unleashed austerity policies across the region that could quash consumer spending, while growth in the United States remains stubbornly anaemic and even China's economy is showing signs of moderating.

Policymakers are bombarding the markets with cash to keep credit flowing to the interbank lending mechanism, which has not fully recovered from the shock of the 2007 credit crunch.

"In a deflationary environment where asset prices are plunging, then by holding its value, gold will outperform. It is a bit of a chameleon and that's what attracts people to it," said RBS head of commodity research Nick Moore.

That said, Moore added he only places a 10 percent weighting in his gold price expectations on the inflation argument itself. He believes gold's safe-haven appeal will ultimately be what spurs it to outperform other asset classes.

Japan is the most widely used example of a developed nation caught in a deflationary spiral, in which prices have essentially declined for more than a decade.

This has not been the case in the United States. The core PCE, the Fed's preferred measure of inflation, has fallen since late 2008, when the credit crunch unfolded, but is still within the bank's target band of 1 to 2 percent.

In the last two decades, the U.S. consumer price index has risen

by 65 percent, while gold has risen by 250 percent.

Looking at the most common market measures of U.S. inflation expectations, the five-year breakeven inflation rate -- derived from subtracting the yield of the benchmark inflation-linked bond from that of the nominal bond -- shows fixed income investors anticipate an inflation rate of around 1.35 percent.

Further out, investors are less sanguine. The 10-year breakeven rate is around 1.80 percent, which although low by historical standards, is up from around 1.5 percent in August.

"This is important for precious metals, not necessarily because we expect inflation to run rampant and push precious metal prices higher, but it signals a move away from deflation fears. A world where debt is an issue, falling prices will only amplify the problem," said Standard Bank analyst Walter de Wet.

Former Fed Chairman Alan Greenspan himself said more than 10 years ago that gold was "the ultimate means of payment".

"There are definitely going to be a group of investors holding gold for financial reasons and that will be inflation/deflation. There will be others who hold it as a safe-haven play," RBS' Moore said.

"It's been a great performer over the last ten years and now it's properly valued and accepted and part of society. Gold before was a bit of a pariah, one of these barbaric relics that no one understood and no one needed and that's now changed."

INTRODUCING THOMSON REUTERS EIKON

THOMSON REUTERS EIKON 

CLICK TO SEE THE DEMO

I'M GOING TO USE IT TO SHOW YOU
WHAT HAPPENS NEXT."

INSIDE DEBT is produced by Reuters in partnership with ICAP.

(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

For Market Snapshot, ICAP provides OTC capital markets data, Thomson Reuters provides exchange data.

Visit the Thomson Reuters Fixed Income Community Site at:

<http://customers.reuters.com/community/fixedincome/>

If you like to receive this in your mailbox, please subscribe at:

<http://interact.thomsonreuters.com/insidedebtweekly/>

For more information about our products:

http://thomsonreuters.com/products_services

Or send us a sales enquiry at: <http://reuters.com/salesenquiry>

North America: +1 800.541.2268



ICAP:

For additional information and to find out more about how ICAP's range of market information, commentary and research solutions can help your business, contact icapinformationservices@icap.com. Americas: +1 212 341 9789

© 2010 Thomson Reuters. All rights reserved. This content is the intellectual property of Thomson Reuters and its affiliates. Any copying, distribution or redistribution of this content is expressly prohibited without the prior written consent of Thomson Reuters. Thomson Reuters shall not be liable for any errors or delays in content, or for any actions taken in reliance thereon. Thomson Reuters and its logo are registered trademarks or trademarks of the Thomson Reuters group of companies around the world.

ICAP plc, its subsidiaries ("ICAP") and third parties own portions of the copyright to information, data and content ("Information") and to certain service marks and logos herein. The Information is for informational purposes only; is not intended as investment, financial or accounting advice; and should not be construed as an offer, bid or solicitation in relation to any financial instrument. All information is provided "as is" without any representations or warranties of any kind. ICAP and third parties shall not be responsible or liable for any damages whatsoever arising out of or relating in any way to the Information herein.

