

Supply, Demand & Curve

8 Feb 2010

GLOBAL DEBT RESEARCH

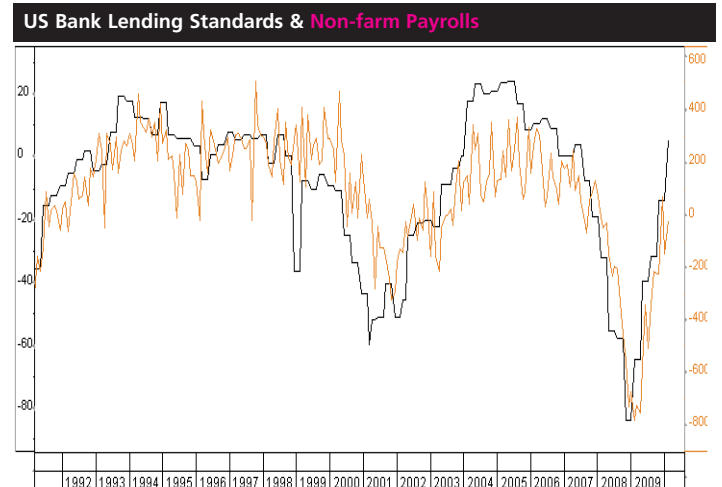
Lender or Borrower be ?

- Financial conditions and credit cycles inextricably linked; improvement in the former eliciting stabilisation of the latter
- Credit stabilisation patently more supply than demand led, but loan demand to rebound with recovering risk appetites
- Private relevering to accommodate benign deleveraging of fiscal balance sheets, bond market vigilantism notwithstanding

"The January survey indicated that commercial banks generally ceased tightening standards on many loan types in the fourth quarter of last year, but have yet to unwind the considerable tightening that has occurred over the past two years" (Federal Reserve, 1 Feb 2010)

Those resurgent vigilantes of the government bond markets were not invited to the latest G7 *bunfest* in northern Canada, but their recent agitations cast a long shadow over this weekend's proceedings. Amid intense market focus on the issue of sovereign credit risk, Canada's Finance Minister affirmed that "we are all agreed continued stimulus is necessary", but that "there is a concern about deficit levels and, when stimulus ends, how we exit". Undoubtedly, expansionary fiscal policies played a critical role in mitigating the global economic fallout from unprecedented private sector deleveraging in recent years. The legacy of such interventions is now revealed by exploded public debt, with IMF extrapolations positing 118% Debt/ GDP ratios for the G20 bloc by 2014, compared with c 80% pre-crisis. With "exit" strategies for fiscal accommodations posing a greater (political) challenge than their monetary equivalents, the prevailing fixations of investors and ratings agencies are not difficult to comprehend. The adverse tail-risk in all of this is that any deepening anxiety regarding future policy risk may trump the benefits of existing policy settings, with jittery markets thereby resurrecting negative feedback loops that might threaten to derail a nascent economic recovery. Thankfully, there is an altogether more likely and benign outcome, one in which the mirror-imaging of recent private deleveraging/ public releveraging is allowed to play out in a more orderly fashion. Indeed, with financial conditions and credit cycles now demonstrably joined at the hip, such benign alternative is already unfolding beneath investors' diverted gaze.

Last week, the latest Fed Loan Officer Survey reported the first net easing in US commercial and industrial (C&I) lending standards since Q2/07, with an improving economic outlook and increased banking competition cited as explanation. Similar trends are also emerging in the European surveys, with UK corporate loan standards now easing for the first time in 8 quarters, and Euroland on the cusp of so doing. While US banks continue to tighten standards across their mortgage books (if at an ever-diminishing pace), there is a distinct improvement in lending conditions for broader consumer credit, not least a notable loosening in standards for installment loans. All told, those pernicious



headwinds of ever-tighter lending standards on US economic growth prospects are now blowing themselves out at a relatively rapid pace by historical standards, being testament to the remarkable improvement in US financial conditions engineered by extraordinary policy interventions during the *post-Lehman* disorder.

Global authorities have therefore succeeded in arresting deleveraging dynamics on the credit supply side, but the demand side continues to lag this process. The latest Fed Survey revealed a further weakening in corporate and consumer loan demand, but these impulses have been fading inexorably over the past 12 months. Whilst outstanding stocks of C&I and consumer loans continue to drop, their pace of decline is slowing, evidenced by Fri's confirm of a scant \$1.7bn fall in consumer credit for Dec, best since Jan/09. Much like with inventory computations for GDP purposes, it is change in the flow of credit, rather than stock, which dictates the directionality of the money multiplier. With inventory, capex and now labour market trends signalling slow but steady revival in private sector risk appetites, a discernible uplift to credit demand will inevitably follow. Of course, by the Fed's own admission, a stabilisation in bank lending standards does not unwind the tightening of the past three years, and standards will remain relatively tight for the foreseeable future. However, this reality will not negate the about-turn in US credit metrics from economic headwind to tailwind.

The global economy and financial markets are now entering a pivotal stage in the *post-crisis* aftermath, their joint objective being to extend positive feedback loops and self-sustaining recovery momentum that will not be dependent on any outsized policy support. If successful, the process of public-sector deleveraging may then proceed apace, starting with highly-inflated central bank balance sheets, but thereafter to more safely encompass the equally bloated balance sheets of those fiscally strait-jacketed and under-the-cosh sovereigns.

A temporary hiatus now beckons for SD&C, returning 22nd Feb.

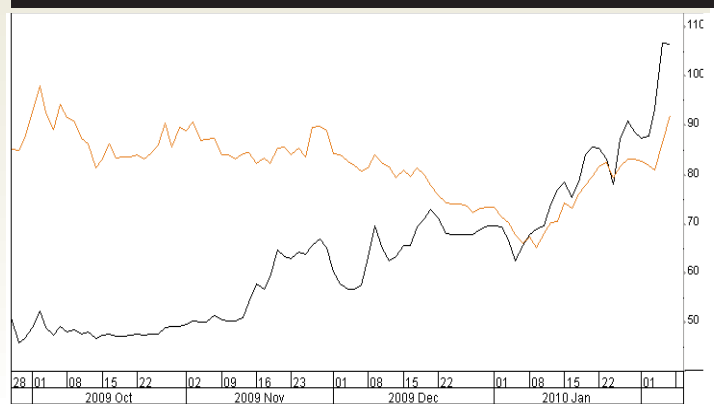
Duration Risk : 10 yr Treasury Yields (with trendlines)



Whether or not "every single human being" should now be betting against US Treasuries (cf Nassim Nicholas Taleb) is a moot point, but the inability of this market to prosper unduly from the latest risk-flight on Wall St appears a clear harbinger of higher yields ahead. Sentiment surveys (SMR, JPM) are resignedly bearish, leery perhaps of those potentially adverse supply/ demand dynamics resultant from QE's demise at quarter's end. In the interim, the ytd flatlining of both Fed custody holdings and US commercial bank purchases may flag bid-exhaustion from these key sponsorship channels. The chart profile for 10yr Treasuries is exhibiting a relatively constrained trading range (3.20%-3.90% broad, 3.57%-3.83% narrow), with 3.57% pivotal as a double-bottom neckline and 4% objective. Any slippage sub-neckline should be braked by the 200dma at 3.51%.

PIIGS could certainly fly last week, or at least that was the case in CDS space, where record spread widening involving some of the more vulnerable sovereigns (Greece, Portugal, Spain) catapulted the SovX index to fresh peaks at 110bps. In so doing, spreads to Main widened to an unprecedented +20bps, while an 8bp premium also briefly opened-up vs senior financials before Fri's unwind. Sovereign default risk is now the cross-market concern *de jour*, such jitters being heightened by sloppy T-bill and short-dated bond auctions in Portugal and Spain. With this supposedly risk-free asset class being subjected to a bearish reprice, osmotic repricing is also playing out across the riskier markets, improving fundamentals notwithstanding. CDS vigilantes may ultimately be a force for good (*vis-a-vis* fiscal consolidation), but their time-table threatens a disorderly passage.

Yield Curve / Spread Risk : iTraxx Europe Sovereign & Main CDS (5yrs)



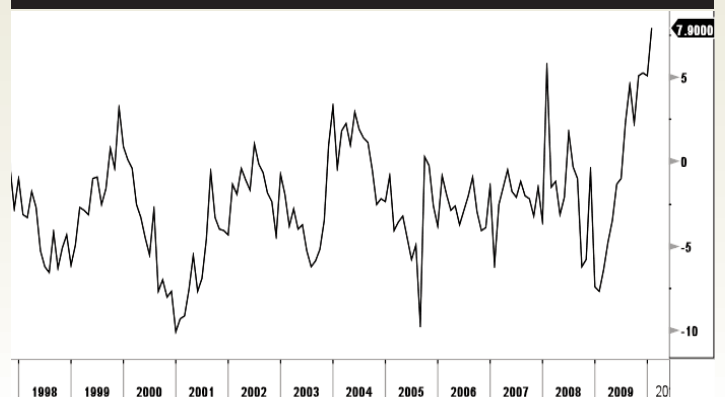
Fri's 80.44 close on the USD trade-weighted index represents the high since mid-Jul/09, and a sharp 8.5% rebound from the 74.17 lows of late-Nov. The Dollar's recuperation was initially triggered by tacit forex interventions (BOJ,SNB), but more recent dynamics have been fuelled by that unfolding risk/ reduction bias across the major asset classes. Catalyst for this has been the spike in sovereign CDS spreads, most especially among Euroland peripherals, the fx impact of which now playing out with some venom on the Eur/USD cross. Signs on, with speculative Eur shorts now posting record extremes *per* weekly IMM data. An over-bought (daily RSI of 75.30) and over-owned TWI is now converging on horizontal chart resistance in the 80.00-80.50 range, being the prominent lows formed during both 1995 and 2004. These barriers appear robust, and defensible.

Foreign Exchange Risk : USD Trade-Weight (with trendlines)



The rebuilding of US inventories from historically depressed levels is having a material bearing on current economic *reportage*. This was clearly evidenced by the advance Q4/09 GDP report, wherein the 21% surge in goods-related expenditure contrasted with the more mundane 1.7% rise in services-related outlays. The inventory effect is also apparent in the ISM surveys, where the outperformance of the manufacturing index (58.4 in Jan, high since Aug/04) over its services equivalent (50.5 in Jan, high since May/08) has reached unprecedented proportions. To be sure, the larger manufacturers are benefiting from the revival in global trade and freed-up credit financing from the debt capital markets. The services industries are necessarily more domestic-demand focussed, where the incipient recovery is still being hampered by a credit-constricted SME sector.

Fundamental Risk : US ISM Survey Gap (Manufacturing - Services)



Strategic

- * Global economies and markets exiting 2009 in much better shape than they were in entering it. The credit crisis is over, financial market conditions are progressively improving, and such improvement has provided the foundation for economic recovery now underway.
- * A combination of zero policy rates, private sector deleveraging and renewed foreign reserves accumulation has driven real interest rates sharply lower, thereby bestowing a reflationary underpinning to real economies and asset values.
- * Investor reaction function recalibrating from systemic to idiosyncratic risk; excess liquidity still ensuring tight cross-market correlations, but prior indiscriminate beta-chasing finally drawing to a close. Fair-value equity markets now in the vanguard of the global reflation trade.
- * Growing fixation with sovereign default risks as public debt/ deficits explode, with credible fiscal "exit" strategies not yet articulated. Such risks more apparent in synthetics than cash, but a rising bond yield trajectory hard to arrest as term premia (policy/ refinancing) rebuild.
- * Dollar now liberated from risk-market enslavement as risk appetites normalise. Outlook hinges on the greater sway of conflicting cyclical (rates) and structural (reserves) forces. Size RMB yuan revaluation a potential wild card for 2010.

Tactical

- * The juxtaposition of rising sovereign credit risk with falling yields in benchmark bond markets is understandable (on risk-aversion flows) but anomalous (on the universality of ballooning fiscal indebtedness). Meanwhile, economic news-flow improving on trend. Short duration.
- * Front-end squeezes reigniting curve steepening trends, with 2/10yr Euroland +6bps to 213bps and 2/30yr Trsys re-testing cycle peaks at 377bps. Stay positioned, given scant ingredients for a trend reversal.
- * Treasury/Bund spreads still hugging the upper echelons of a 40/50bp range in 10yr mats, with this week's supply-fest threatening a break-out. Stay positioned. Retain long Aud vs Cad in the USD-bloc, and ditto selective E/land peripherals (nb Ireland) vs core. Revert to short UK amongst the "opt-outs", but still long JGBs and IL.
- * Roiling sovereign CDS spreads have forced synthetic credit indices wider, but the cash markets are more tempered in response for both US high-grade (+188bps) and high yield (+681bps). Cash technicals also becalmed as a tactical supply embargo extends. Overweight.
- * Broadening sovereign credit crisis is playing to the strengths of more deeply-liquified USD markets, the Dollar trade-weight now atop key resistance at 80.50. The Greenback is over-bought and over-owned, while Eur/USD has satisfied a requisite 10% correction. Raise hedges.

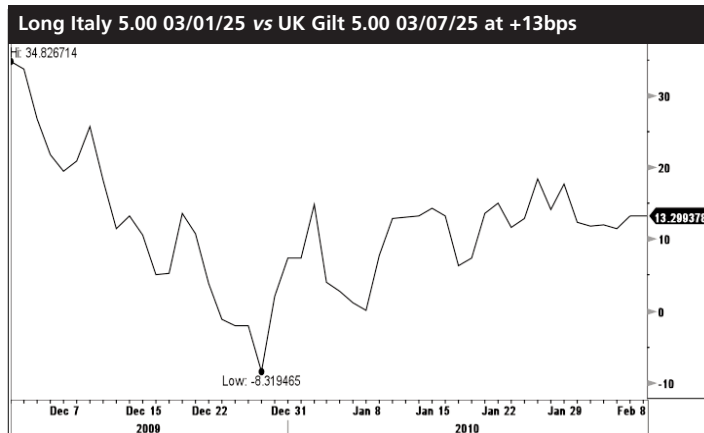
Model Portfolio

Country	Benchmark*		Market	Duration	Yield Curve			Issuer	ActiveFx**
	Weight	Duration			1 -5	5 -10	10+		
US	22.30%	5.61	-	-	+	-	N	HG	-
Canada	2.03%	7.05	-	-	+	-	N	HG	N
Australia	0.37%	4.70	+	-	+	-	N	HG	N
Germany	10.65%	5.87	N	-	+	-	N	HG	Base
France	9.24%	5.77	N	-	+	-	N	HG	Base
Holland	2.66%	5.22	N	-	+	-	N	HG	Base
Italy	9.71%	6.91	+	-	+	-	N	HG	Base
Spain	3.67%	5.97	+	-	+	-	N	HG	Base
Belgium	3.07%	5.72	N	-	+	-	N	HG	Base
UK	5.32%	8.04	-	-	+	-	N	HG	-
Sweden	1.00%	4.79	N	-	+	-	N	HG	N
Denmark	1.02%	44	N	-	+	-	N	HG	N
Japan	28.95%	5.61	+	-	+	-	N	HG	N
		6.00		-					

* JP Morgan

**Euro Base

Best Trade



Jean-Claude Trichet did his level best to shore-up confidence in the "solidity" of the Euroland project last Thu, affirming that its current economic situation compares "very flatteringly with a number of other (major) industrialised countries". Such is undoubtedly true at the aggregate level, given the average fiscal deficit (6% GDP) slated for 2010. However, current market fixations are at the individual country level, such that the sum-of-the-parts EU sovereign credit risk (per CDS) now appears substantially greater than that of the whole, a reflection perhaps of the sub-optimality (ie fiscal disunion) of the single currency zone. Cross-country comparisons on a twin-deficit basis reveal some bond-pricing anomalies, and not least vis-a-vis Euro/UK spreads, where the latter market faces a risk premium (policy, refinancing) rebuild now that QE distortions have expired.

Event Watch

	Monday 08 Feb	Tuesday 09 Feb	Wednesday 10 Feb	Thursday 11 Feb	Friday 12 Feb
UNITED STATES	3 & 6 mth T-bills	ICSC/ Redbook (6 Feb) Wholesale Invents (Dec) 4 & 52 wk T-bills 3 yr Treasuries	ABC Cons Con (7 Feb) MBA Survey (5 Feb) Trade Balance (Dec) EIA Stocks (7 Feb) Treasury Balance (Jan) 10 yr Treasuries Bernanke Test (Wash)	Initial Claims (6 Feb) Retail Sales (Jan) Business Invents (Dec) 30 yr Treasuries	Michigan Sent (Feb)
CANADA			Trade Balance (Dec) 3 yr Canada	House Prices (Dec)	Auto Sales (Dec)
JAPAN	Current Acc (Dec) M2 Money Supply (Jan)	30 yr JGBs	Machinery Ords (Dec) Domestic CGPI (Jan)	Holiday	
AUSTRALIA			Consumer Sent (Feb) Housing Finance (Dec) Unemployment (Jan)		
EUROLAND	FRA BDF Bus Sent (Jan) IRL HICP (Jan) EUR Sentix Index (Feb)	GER Current Acc (Dec) GER VDMA Ords (Dec) GER HICP (Jan) NET 5 yr DSL AUT 10 & 16 yr RAGB	FRA Indust Prod (Dec) GER W/sale Prices (Jan) FRA Current Acc (Dec) ITA Indust Prod (Dec) SPA GDP (Q4) GRE HICP (Jan) GER 10 yr Bund	ECB Monthly Bull (Feb)	EUR Indust Prod (Dec) GER GDP (Q4) FRA GDP (Q4) NET Retail Sales (Dec) ITA BTPs Nowotny Speech (Wien)
UNITED KINGDOM	M0 Money Supply (Jan)	BRC Retail Sales (Jan) RICS Survey (Jan) Trade Balance (Dec) 24 yr Gilt	Industrial Prod (Dec) NIESR GDP est (Jan) BOE Inflatn Report (Q1)	Mortgage Reposs (Q4) 12 yr Linker	Construction Exp (Q4) Leading Indic (Dec)
SWEDEN			GDP (Q4) Industrial Prod (Dec) New Orders (Dec) 10 yr SGB	Riksbnk Policy Announce	
DENMARK			HICP (Jan)		

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