

Weekly Market Commentary

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Overview Interbank and Treasury yields are mostly lower again as we ponder what comes next. Spreads between Libor and Official Interest rates are at their narrowest since the crisis erupted on our radars, pushing some money market futures contracts to new record highs (Eurodollar 99.4625 and Euribor 99.050). This dragged two-year benchmark yields down, German ones dropped 60 basis points to 1.215% over the last four weeks, US ones – 50 bp to 0.9775%, and Japanese to 0.250% their lowest since December 2005. Equity indices dipped a little, many trading towards their lowest levels of the last two months or so. The FX market was quiet again, the South African rand gaining most against the US dollar to 7.6700, the Kiwi slipping the most, while Eastern European currencies recovered their poise. Commodities were mostly unchanged though a 'rogue trader' managed to lose about \$10M on oil futures for his broking firm and ICE #11 Sugar futures surged to 18.00 cents per pound, their best since April 2006 and one of the highest prices in thirty years.

Political and Economic Developments Sweden, marking its EU presidency with a -25 bp rate cut to a record low 0.25% and offering banks 100B krona for a year because 'the situation on the financial markets is still not completely normal' - an understatement from the Riksbank. Indonesia also cut -25 bp to a record low 6.75% warning 'monetary policy will be conducted more cautiously'. Keeping its key rate at 1.00%, the ECB's Trichet left the door open to further easing by reiterating: 'we did not decide today that this was the lowest level we would ever attain under any circumstances' – after convincing banks to borrow bucket-loads at rock bottom rates last month. The US Mortgage Bankers Association said seasonally adjusted loan applications, both new and for refinancing, dropped -18.9% to a seven month low. A combination of interest rates over 5.00%, job losses and difficulty selling existing property are to blame. Aware that those with negative equity in their homes cannot apply for refinancing, President Obama extended subsidies from mortgages 5% higher than the value of the property to those with 25% more debt than equity. Estimates suggest one in ten Americans are underwater by 30% - or more! UK Q1 revised GDP dropped a whopping -2.4% Q/Q, almost 1958's record low -2.6%, a record -4.9% Y/Y and worse than anything seen in the crisis-ridden 1970's.

Underlying Themes Russian bankers will have to enjoy the ultimate 'staycation': President Putin has told them to keep away from the Riviera, lend another 400-500B roubles by October, and sort out the economic mess at home. Citizens of the Eurozone may have no choice either with a record 9.5% of them unemployed in May, matching the US's 9.5% in June – and likely to get worse this summer. Those on 'short time' massively higher too, especially in Germany where new rules mean about 1.3M are in this situation and in the US part-timers have doubled over the last 18 months to 3.2M. Better than no work at all but no money for luxuries either; the Average US Workweek now a record low 33 hours (from 39 in the 'sixties) and wages growing at 2.7% annualised from the 4.00% level 2005-2008. In Japan the Job-to-Applicant Ratio is at a post-war low 0.44. Many putting a brave face on it claiming a desire for a better work/life balance.

What to watch for next week Sunday 5th a parliamentary election in Bulgaria and a presidential one in Indonesia Wednesday. Monday Japanese May Leading and Coincident Indices, US June Non-Manufacturing ISM, Eurozone July Sentix Index and finance ministers meet in Brussels. Tuesday the Reserve Bank of Australia decides on rates (unanimously expected unchanged at 3.00%), UK May Industrial Production and German Factory Orders. Wednesday Japan May Machine Orders and Trade Balance, June Bankruptcies and Economy Watchers' Survey, UK Nationwide Consumer Confidence, BRC Shop Price Index and NIESR GDP, EZ16 final Q1 GDP, German May Industrial Production and US Consumer Credit while a G8 Summit begins in Italy. Thursday the Bank of England's MPC is expected to keep rates at 0.50%, German and UK May Trade Balances and US Wholesale Inventories. Friday Japan June Domestic CGPI, UK PPI, US May Trade Balance and July University of Michigan Confidence Survey. Sunday 12th Tokyo assembly election seen as a dry run for general elections later this year while US Treasury Secretary Geithner flies out to Europe and the Middle East to discuss the financial crisis.

Positioning and Technical Analysis We continue to worry that in holiday-thin market conditions this summer could exact some heavy losses. Low volumes and sharp intra-day price moves may become the norm as so often has been the case in the last ten years or more. We still feel that top-quality long-dated fixed income real yields are generous and might have further to drop over the long term, flattening yield curves. Stock markets are likely to break through pivotal support that propped many up this week, the move gathering steam the lower we go, forcing many into another U-turn. Generalised US dollar weakness will continue, possibly with a big spurt during the next fortnight. Commodities will follow. Have a nice weekend!