

Global Markets Weekly

Investors shrugged off a lack of detail on Greek bailout plans, but got the jitters from a rise in the Fed's discount rate.

Equity markets enjoyed decent gains early in the week, despite a lack of detail from European Finance ministers on bailout plans for Greece. The focus turned to positive data such as Japanese fourth quarter GDP and US industrial production. By Thursday's close the S&P 500 was up 3% on the week, before "after-hours" news that the US Federal Reserve (Fed) was increasing its discount rate caused equity markets to pare their gains on Friday, especially in Asia. The dollar also strengthened against the Euro. In bond markets, UK 10-year yields reached their highest levels in 15 months, surpassing Italian yields.

Japan's growth is trending higher, but yet to shake off deflation.

Japanese GDP grew at a stronger-than-expected 4.6% annualised pace in the final three months of the year. Although Japanese GDP data can be extremely volatile, the figures confirmed an improving trend in the underlying annual growth rate. Still, deflationary pressures remain entrenched, with consumer prices around 2% lower than a year ago.

The Fed's move caused a stir, but banks had already sharply curtailed borrowing at the discount rate.

The Fed's move to raise the discount rate it charges banks for short-term borrowing, by 25 basis points to 0.75%, caused a stir. However, the Fed emphasised that raising this rate was part of a very gradual process of removing emergency stimulus measures and that its key fed funds rate will remain "exceptionally low" for "an extended period." The discount rate is normally higher than the fed funds rate, to encourage inter-bank lending for short-term liquidity needs. As conditions in inter-bank markets have normalised, it made sense for the Fed to begin gradually returning the discount rate to its normal spread over fed funds. Indeed, lending at the discount rate had already fallen to \$53 billion (bn) from \$590 billion (bn) in December 2008.

UK inflation breach is less of a concern than weak growth for the BoE.

A busy week for UK data included a spike in January inflation to 3.5%, forcing Bank of England (BoE) Governor Mervyn King to write an open letter to the Chancellor explaining the significant breach of the 2.0% target. King cited short-term factors such as the VAT increase and oil prices, while also recognising a possible delayed impact from sterling weakness. Given the slack in the economy and weak wage growth, the BoE expects inflation to fall below its 2% target in the medium-term. Indeed, minutes from the bank's latest policy meeting showed a 'finely balanced' decision to pause quantitative easing this month.

Deteriorating UK finances put gilts and sterling to flight.

News on Thursday that the UK had its first budget deficit for the month of January since records began in 1993 led to a sharp fall in sterling and gilts into the end of the week. The UK yield curve was already at record steepness, as measured by the spread of 10-year over two-year gilt yields. It could steepen further into the general election, especially if uncertainty persists about whether the next government will have the determination and ability to tackle the deficit.

Signs of 'jobless recoveries' in the UK and US raise concerns about consumer strength.

Finally, the number of people claiming unemployment benefit unexpectedly rose by 23,500 to 1.64 million, although the UK unemployment rate remained constant at 5%. US weekly jobless claims were also higher than expected. This is typical of anaemic recoveries, which lack the strength to get companies hiring in large enough numbers to bring unemployment down quickly. It also means that wage growth, consumer confidence and spending could remain soft even as developed economies recover from their worst recession in 60 years.

Carl Astorri, Coutts & Co

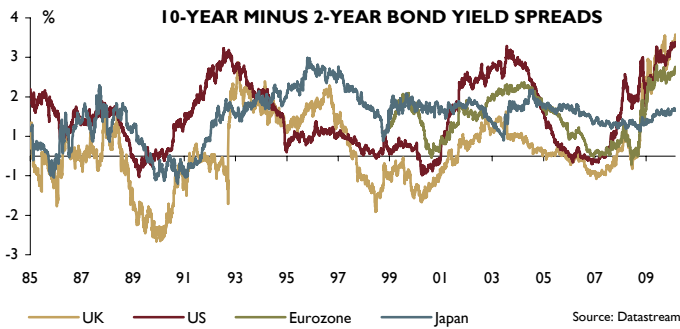
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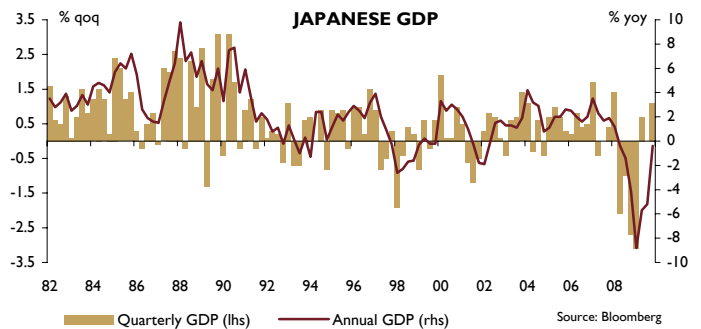
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Charts of the Week

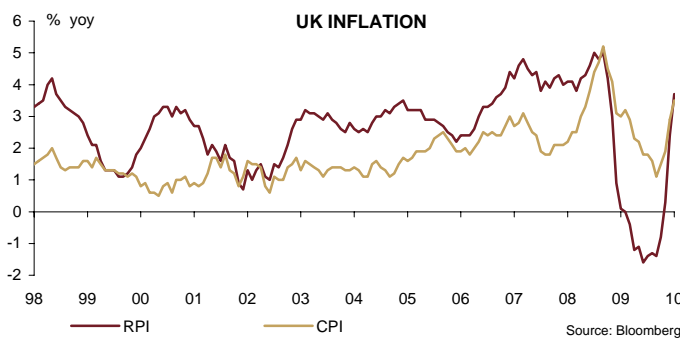
UK yield curve steepens further to new record high on fiscal concerns and spike in inflation



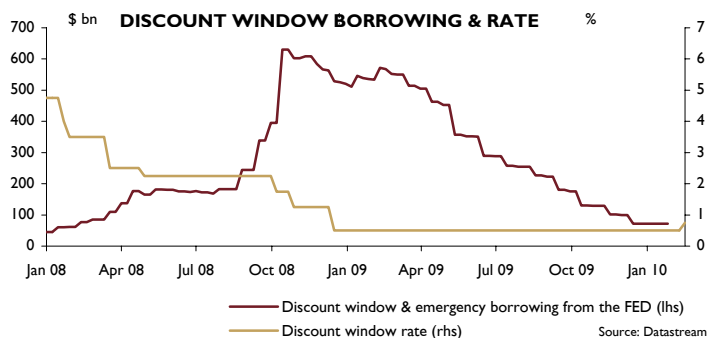
Japanese growth volatile, but underlying trend is improving



UK inflation spike continues, driven by VAT and energy price increases, though Bank of England unperturbed



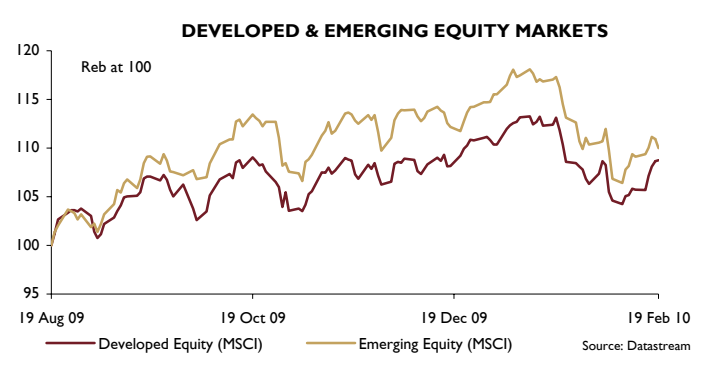
Federal Reserve lifts discount rate as banks diminish their reliance on emergency borrowing



Market Performance

Equity Markets As of: 19-Feb-10	Current	Performance (% local)				
		-1W	-1M	-3M	YTD	09
Developed Equity (MSCI)	820	2.9	-3.9	1.4	-1.5	22.8
FTSE All Share	2,742	4.1	-2.6	1.7	-0.7	25.0
FTSE 100	5,358	4.2	-2.8	1.7	-1.0	22.1
S&P 500	1,109	3.1	-3.6	1.3	-0.5	23.5
Nasdaq Composite	2,244	2.8	-3.3	4.0	-1.1	43.9
DJ EuroStoxx	262	4.0	-5.9	-1.6	-4.5	23.4
Nikkei 225	10,124	0.3	-6.0	6.0	-4.0	19.0
Hang Seng	19,894	-1.9	-8.2	-12.1	-9.1	52.0
Emerging Equity (MSCI)	41,068	0.8	-6.2	-2.5	-4.8	58.6
BRIC (MSCI)	505	0.6	-7.2	-4.8	-5.4	68.0

Source: Datastream



10-Year Bond Yields As of: 19-Feb-10	Current	Change (basis points)				
		-1W	-1M	-3M	YTD	09
US Treasuries	3.8	8	8	41	-6	158
UK Gilts	4.3	13	15	52	16	102
Euro Bonds	3.3	9	1	6	-10	44
Japanese Bonds	1.4	0	0	3	4	11

Source: Datastream

Commodity Markets As of: 19-Feb-10	Current	Performance (%)				
		-1W	-1M	-3M	YTD	09
Commodities (TR)	271	2.9	-2.6	0.1	-3.1	18.9
WTI Oil Price (Spot)	80	7.7	1.0	2.8	0.7	102.4
Gold Bullion (Spot)	1119	3.0	-1.2	-1.5	2.1	27.1
Industrial Metals (TR)	345	7.7	-3.2	8.1	-1.2	80.0

Source: Datastream

Interest Rates & Inflation

Inflation & Interest Rates		Current Inflation (%)	RBS Interest Rates Forecast (%)			Rate Announcement Next Date
			Current	Mar'10	Jun'10	
United States	(Fed Funds)	2.6	0.25	0.25	1.00	16-Mar
United Kingdom	(Base Rate)	3.5	0.50	0.50	0.50	04-Mar
Eurozone	(Repo Rate)	0.9	1.00	1.00	1.00	04-Mar
Japan	(Call Rate)	-1.7	0.10	0.10	0.10	17-Mar

Source: Coutts, RBS, Datastream

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