

Global Markets Weekly

Plans for sweeping US banking reforms took the markets by surprise and knocked investor confidence.

As we warned last week, it was likely to take a surprise event to seriously disrupt investor confidence. This happened on Thursday, when President Obama announced the most sweeping reforms to the US banking system since the 1930s. If the proposals make it into law, banks will no longer be allowed to engage in proprietary trading, or finance hedge funds. They will also be reduced in size, so that they are no longer 'too big to fail'. The market reaction was swift, with the S&P500 down almost 2% on the day, and large banks particularly hard hit.

Wobbles triggered by Chinese tightening highlight the shifting balance of power in the global economy.

Wednesday had already seen stock and commodity market declines, especially base and precious metals, on the back of more monetary tightening by the Chinese authorities to cool the economy and head off inflation. The dollar also rallied on increased risk aversion and the eurozone's ongoing problems with Greece.

Chinese GDP grew a stronger-than-expected 10.7% year-on-year (y/y) in the fourth quarter (Q4), against 8.9% in Q3, and inflation also accelerated more quickly in December than anticipated. In response, the Chinese Banking Regulatory Commission announced that it had ordered banks to cut back on new lending and asked certain banks to halt new lending altogether. A look at past recoveries from a secular bear market shows that there are often 'wobbles' linked to anticipated Federal Reserve tightening. However, this time Chinese monetary tightening has triggered wobbles, highlighting the shift in the balance of power in the global economy from the US to China.

Democrats' loss of US senate seat adds political uncertainty to investors' concerns.

The sell-off on Wednesday may also have been linked to the loss of a senate seat for the Democrats after their defeat in Massachusetts, which makes passing legislation harder. This increases the likelihood that Bush-era tax cuts will be left to expire in 2011 and reduces the prospects for a large second stimulus package to be introduced in late 2010, even if the economy slows in the latter half of the year.

UK inflation leapt in December, but this was largely down to exceptional factors depressing year-ago prices.

Fears about UK inflation also mounted after it leapt a full percentage point in December to 2.9%, well above expectations and the biggest increase over the previous month ever recorded. The Office for National Statistics highlighted a number of exceptional factors – a fall in oil prices, VAT reduction and pre-Christmas discounting - that led to steep price declines back in December 2008, thereby boosting the y/y comparison. These three factors alone accounted for the vast majority of the jump in headline CPI inflation, and without the VAT change inflation would have actually fallen. However, city forecasters have underestimated UK inflation in nine of the last 12 months, suggesting that there could also be other factors at work. They may, for example, be underestimating the impact of a 20% fall in the value of sterling over the past two years on import prices.

King dampens rate-hike speculation, likening UK inflation figures to "disco dancing."

Bank of England Governor Mervyn King dampened expectations of an early increase in UK interest rates in response to the inflation numbers, saying that "macroeconomic data resemble old-fashioned disco dancing – sharp movements in unpredictable directions creating much excitement, accompanied by a good deal of noise."

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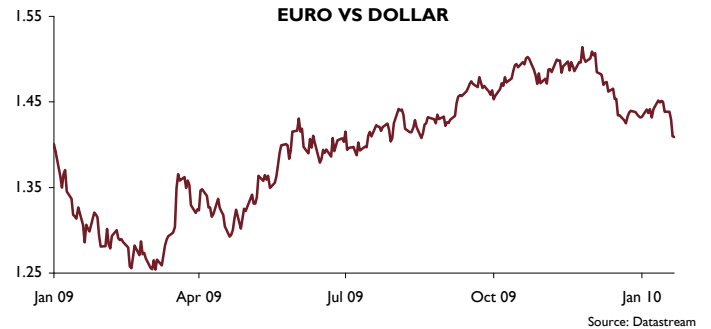
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Charts of the Week

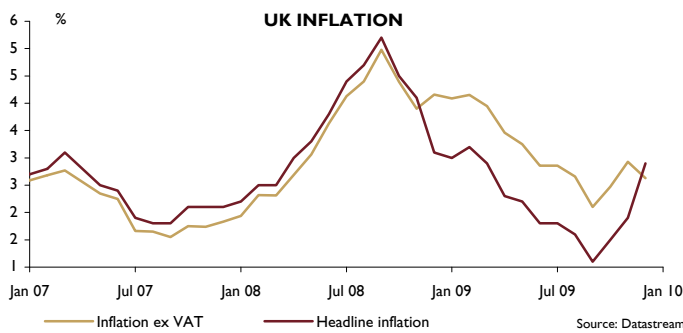
China grows at fastest pace in two years; officials respond with more monetary tightening



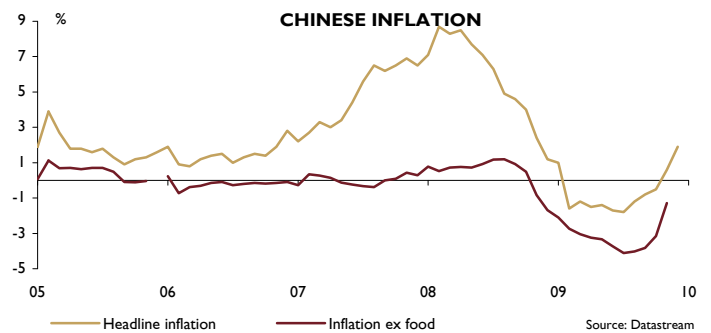
Euro at weakest level against dollar since August 2009 amid concerns about Greek debt



VAT changes add to UK inflation in December, but rate rises not foreseen



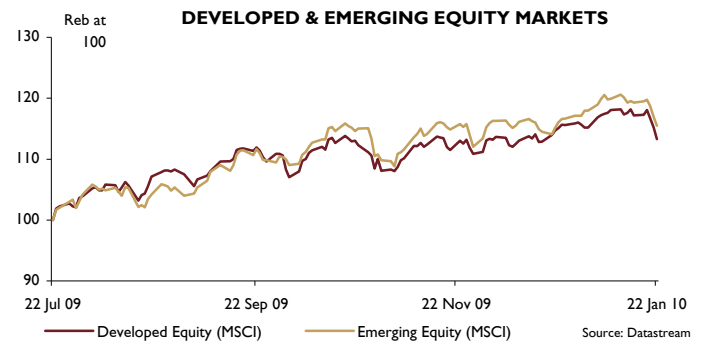
Chinese inflation picks up, back in positive territory, adding impetus to central bank tightening



Market Performance

Equity Markets As of: 22-Jan-10	Performance (% local)					
	Current	-1W	-1M	-3M	YTD	09
Developed Equity (MSCI)	819	-3.3	-1.2	0.2	-1.6	22.8
FTSE All Share	2,714	-2.7	-0.1	1.5	-1.7	25.0
FTSE 100	5,303	-2.8	-0.5	1.8	-2.0	22.1
S&P 500	1,092	-3.9	-2.4	-0.1	-2.1	23.5
Nasdaq Composite	2,205	-3.6	-2.1	1.9	-2.8	43.9
DJ EuroStoxx	267	-3.2	-2.4	-2.0	-3.0	23.4
Nikkei 225	10,591	-3.6	2.1	3.2	0.4	19.0
Hang Seng	20,726	-4.3	-1.7	-6.7	-5.2	52.0
Emerging Equity (MSCI)	42,230	-3.2	0.3	0.8	-2.1	58.6
BRIC (MSCI)	519	-3.9	-0.1	-1.3	-2.9	68.0

Source: Datastream



10-Year Bond Yields As of: 22-Jan-10	Change (basis points)					
	Current	-1W	-1M	-3M	YTD	09
US Treasuries	3.6	-7	-15	19	-23	158
UK Gilts	4.0	-3	1	21	-10	102
Euro Bonds	3.2	-6	-5	-9	-18	44
Japanese Bonds	1.4	0	7	-4	3	11

Source: Datastream

Commodity Markets As of: 22-Jan-10	Performance (%)					
	Current	-1W	-1M	-3M	YTD	09
Commodities (TR)	271	-2.3	0.0	-2.2	-3.1	18.9
WTI Oil Price (Spot)	74	-5.3	0.7	-8.7	-6.9	102.4
Gold Bullion (Spot)	1092	-3.6	1.2	3.5	-0.4	27.1
Industrial Metals (TR)	344	-2.2	2.3	7.7	-1.7	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)	2.7	0.25	0.25	1.00	27-Jan
United Kingdom	(Base Rate)	2.9	0.50	0.50	0.50	04-Feb
Eurozone	(Repo Rate)	0.9	1.00	1.00	1.00	04-Feb
Japan	(Call Rate)	-1.9	0.10	0.10	0.10	26-Jan

Source: Coutts, RBS, Datastream

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