Global Securities Finance *Market Monitor*

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>> Money Markets Recap

Economic data released early in August continued to support the theory that the U.S. economy was on a solid growth path. At the same time, the inflation data seem to confirm the view of the monetary policy makers that there were upside pressures to be concerned about. In summary, it seemed abundantly clear that the FOMC was going to continue its course of rate increases into the foreseeable future. The federal funds futures markets indicated that a rate increase of 25 basis points in both August and September were a virtual certainty and that a further increase in November was greater than an 80% probability. In view of these conditions, we became a bit more cautious in regard to cash collateral investments, especially on any longer term outlook. The scenario changed dramatically on the last 2 days of the month as a major storm hit the Southeastern U.S., with the potential of disrupting energy production and distribution, as well as the shipping of goods through the Port of New Orleans. The market reacted quickly and severely as events unraveled. The yield on the 2-year U.S. Treasury note decreased by over 20 basis points, and by about 15 basis points on the 10-year note. The October federal funds futures contract, which as mentioned above had indicated a 100% probability of a 3.75% target rate, rallied by 6 basis points, therefore dropping the probability of an increase at the September meeting to less than 80%. Clearly, there will be carryover from the late month activity into September, and it will be interesting to follow where the market goes during the first half of the new month. We will remain cautious, and continue to seek to extract maximum value in our trading strategies.

>> Euroland Update

Evidence is still tentative, but economic growth probably is strengthening this quarter, gradually overcoming a moderation in earlier moths. Manufacturing ended last quarter with a bit more momentum and, although hard evidence this quarter is unavailable, business sentiment improved somewhat in July-August. The upward trend in exports and order in 2Q also support that view. More importantly, there are increasing signs of a recovery, albeit moderate, in business investment. Higher oil prices continue to pose some downside risks to the recovery – and hence of stable rates until well into next year. A long as underlying inflation remains contained and the expansion stays fragile, monetary policy probably will remain on hold.

>> United Kingdom Market Update

Q1 GDP growth was, as expected, revised up from 0.4% QoQ to 0.5. The split shows consumer spending staying weak, offset by a sharp 1.5% gain in investment. As well as sluggish real growth, the figures suggest that nominal growth rates are all the weakest for several years. The YoY growth of nominal consumer spending is the weakest for 38 years. The MPC recently argued that the current level of base rates is low enough to produce a marked acceleration in nominal GDP growth over time, hence allowing on-target CPI inflation and real GDP growth that is well above trend. With Q2 data showing weak consumer spending, sluggish business investment and weak nominal GDP growth, we suspect the MPC is overly optimistic. Further monetary easing is likely to be needed to achieve the desired acceleration in real and nominal GDP growth.

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