



GLOBAL MARKETS MONITOR

Friday, May 07, 2004

Global Markets Analysis Division

International Capital Markets Department

Dow	10,241	(-0.7%)	Nikkei	11,439	(-1.1%)	US 10-Yr.	4.60%	(2)	€	1.208	(0.0%)
S&P 500	1,114	(-0.7%)	FTSE 100	4,498	(-0.4%)	Ger 10-Yr.	4.22%	(1)	¥	110.63	(-0.8%)
Nasdaq	1,938	(-1.0%)	Eurotop 300	991	(-0.3%)	Jpn 10-Yr.	1.48%	(-2)	EMBI+	522	(-1)

- **Prospect of rising short-term rates hangs over markets**
- **US payrolls exceed expectations by a wide margin, sending US treasury yields and the dollar higher and US and European equities lower**
- **Oil spot and futures approach \$40 per barrel as concerns mount over oil supplies and gasoline shortages**
- **Feature: Interest Rate Fears Bedevil Emerging Bond Markets (pages 7-8)**

Mature Equity Markets

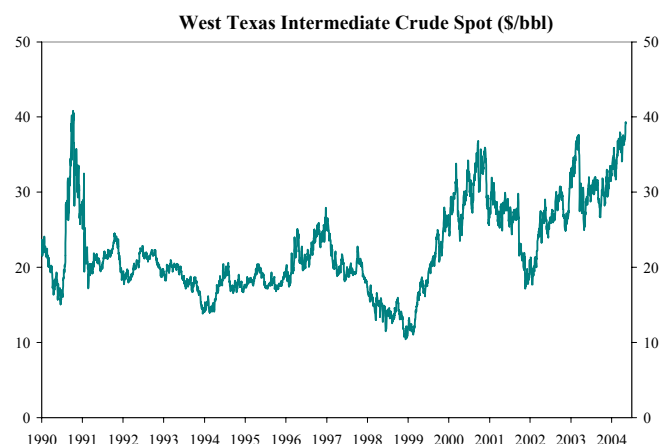
Interest rate jitters pressured US markets Thursday. The Dow and S&P 500 lost 0.7%, and the Nasdaq fell 1.0%. Economic releases continue to suggest economic strength, a firming job market, and rising inflationary pressure, raising expectations for monetary tightening. **The prospect of higher interest rates continues to trump the benefits of a robust recovery.** Citigroup dropped 2.3% after disclosing the SEC was investigating its Argentine operations. In this morning's trading in Europe, US stock index futures declined on concerns over higher interest rates following the higher-than-expected growth in payrolls

European markets are trading mostly lower today, but losses are modest. Defensive stocks are outperforming.

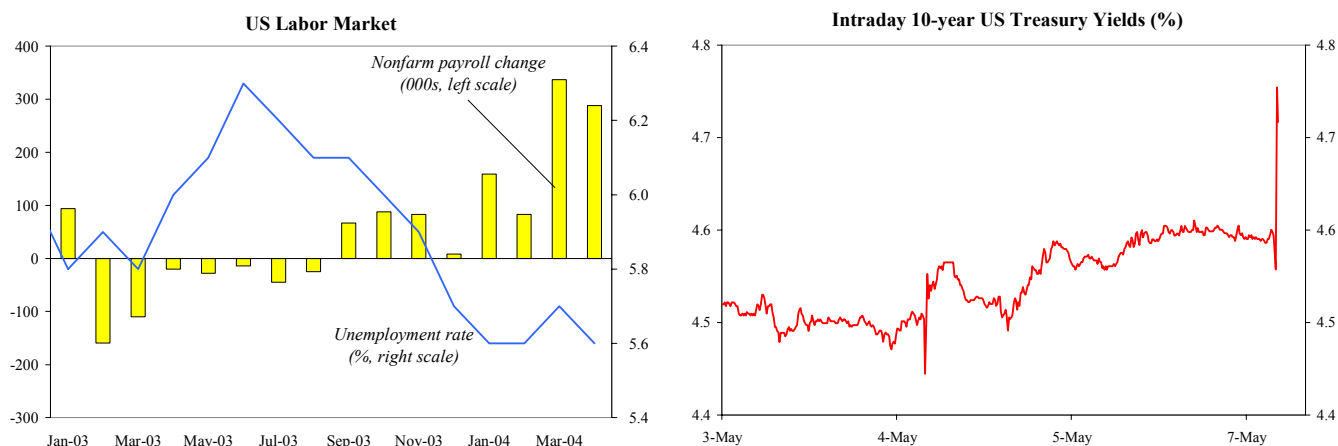
In Japan, the Nikkei fell again Friday as a growing scandal over missed pension payments forced Cabinet Secretary Fukuda to resign, and threatened to force FM Tanigaki also to stand down. The Nikkei closed down 1.2% as exporters continued to be pressured. Toyota fell 1.8%, Fuji Photo dropped 4.2%.

Mature Debt Markets

US government securities weakened Thursday. The yield on the 2-year Treasury rose 5 bps to 2.38%, and the 10-year 2 bps to 4.60%, a 2-year high. Initial jobless claims came in at 3-1/2 year low last week, while unit labor for the quarter were 0.5% against expectations they would be flat. **Oil trading near \$40/bbl in the US** also contributed to inflationary concerns.



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In trading this morning, U.S. treasury yields are sharply higher following data released this morning showing that payrolls grew by 288,000, well above expectations of 170,000. Jobs were added in the manufacturing, construction and temporary help service sectors. The unemployment rate fell to 5.6%. Analysts commented that a firming labor market, a slower pace of productivity growth, and rising unit labor costs would push the pace of interest rate increases. Following the data release, Fed fund futures moved forward the date of an increase in rates, and now appear to be discounting a 60% probability that the Fed will initiate this tightening cycle in June.

European government bonds continue to focus on US developments. Longer-dated government yields hit 3-month highs. German industrial production unexpectedly dropped 2.3% in March, owing to a slump in construction. Swiss unemployment had its biggest fall in 4 years.

Showing some independence from global forces, **Japanese government bonds rose again** Friday, with the yield on the benchmark 10-year JGB declining another 2 bps to 1.475%. Analysts said worries about the future strength of growth in China added to domestic political confusion to increase the appeal of government bonds.

Mature Currency Markets

Ahead of this morning's payrolls release, the **dollar was steady against the euro, but stronger against the yen**. The yen was pressured by weakness in Japanese equities and the resignation of the Cabinet Secretary who admitted not paying pension premiums. The quarterly monetary policy statement by the Reserve Bank of Australia was gauged as dovish by analysts, which could lessen demand for the Australian dollar. The dollar strengthened sharply following the payrolls release this morning.

Emerging Market Debt

The spread on the EMBI+ is little changed in this morning's trading.

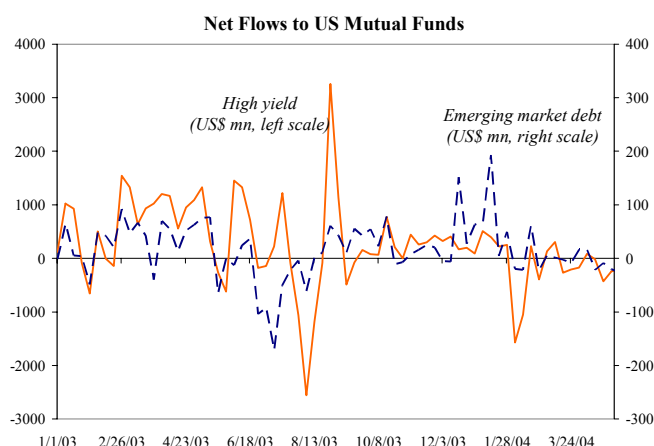
Emerging market sovereign debt suffered its largest daily decline since July 2002 yesterday, with the EMBI+ widening 32 bps to 522 bps (-2%), above 500 bps for the first time in seven months (please see today's feature). The sell-off—widely attributed to concerns over rising US interest rates ahead of today's US employment data release—was surprising in its breadth and intensity. Losses were suffered

across the board, with high-yield Latin credits as usual most affected. Brazil spreads widened 53 bps to 722 bps (-2.7%), with trading also reportedly affected by the loss of a crucial vote for the government in congress. The benchmark C-bond fell 1.65 points in price to end at 90.153 while Global 40s fell 2.9 points to 89.385, back to the levels of August of last year. Colombia, Ecuador, Peru and Turkey all widened 40-50 bps and lost 2%-3%. Most other credits, including high-grade names, were down 15-30 bps and lost 1%-2%.

In ratings news, **Fitch cut Poland's foreign currency outlook to stable from positive** and downgraded its long-term local currency rating to A from A-plus, citing political uncertainty affecting the outlook for fiscal reform.

Slovakia (rated A3 by Moody's and BBB+ by S&P) issued a 10-year bond totalling euro 1 bn (\$1.2 bn) at a favorable yield six days after joining the EU. The bond was priced to yield 4.571% about 35 bps over bunds. The issue has been favorably received and is trading at a yield of 3.89%

Mutual fund flows revealed that the move away from higher-risk assets in the past week took place across the board. AMG data for dedicated emerging market mutual funds surveyed showed net outflows of \$25.6 million in the week ending May 5th, a decline of 2.2% in assets under management, and the highest decline this year. Emerging market equity funds also experienced large net outflows of \$410.97 million, a decline of 3.8% of assets under management, by far the largest decline this year. Finally, corporate high-yield funds showed a net outflow of \$200.6 million, a decline of 1.1% in assets under management.



Latin America

Local markets across Latin America were hard hit by the external debt sell off. Currencies depreciated across the board, in some of the largest daily moves since the middle of last year. Among the hardest hit was the Chilean peso, which weakened 1.3% to 630.6 pesos per dollar, reportedly in reaction to Fed Chairman Alan Greenspan's statements about a slow down in China affecting commodity prices. The Brazilian *real* weakened 1.5% to 2.996 *reais* per dollar with local political developments weighing on markets (see below). **Stock markets also fell across the board**, with the Merval falling 2.6%, Bovespa falling 4.2%, Colombia's IGBC falling 2% and the Bolsa falling 2.6%. Although some country-specific developments affected markets, the overarching theme was a repositioning of investors ahead of the unemployment data releases today.

Brazil

The loss of a vote in Congress for the government exacerbated the effects of the external debt sell-off. The senate voted down a measure designed to close down the Bingos (gambling institutions) in response to the Diniz scandal of earlier this year. Markets saw this as an important defeat for the Lula administration, which may also be facing political pressure from an ad-hoc committee to raise the minimum wage. Local interest rates rose with the Pre curve contract for January 2005 (the most liquid) rising by 12 bps to 15.63% while the April 2005 contract (the second most liquid) rose 20 bps to 16.14%.

Asia

China

Moody's said bad loan provisions may rise when the central bank increases interest rates. Higher rates would help curb loan demand in the booming eastern cities, but would also pressure leveraged state borrowers in the less developed parts of the country, forcing banks to raise provisions for bad loans made to those firms. Ample deposits at banks will keep banks under pressure to lend, so strong administrative measures will be necessary to prevent unwise lending, Moody's said.

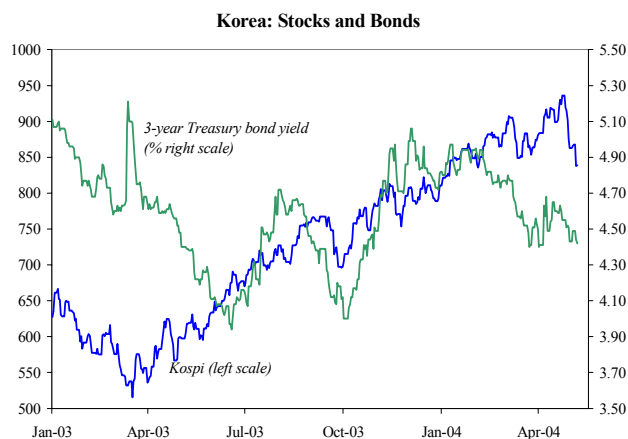
Following the comments yesterday from US Fed chairman Greenspan that slowing growth in China could lead to declines in commodities prices, **analysts are interpreting recent comments from Chinese premier Wen Jiabao as suggesting the timetable for adjustment in China may be long.** Wen reportedly said the government is keen to have a flexible currency, but this will have to await structural improvements in the financial system, and the right macroeconomic environment.

Hong Kong SAR

Strong demand from visitors from mainland China helped retail sales increase a better-than-expected 9.4% yoy in March, down from February's 13.1%, but the eighth straight monthly rise in sales. However, stocks fell on fears of the impact of higher domestic interest rates on banks and developers. HSBC lost 0.4% as the benchmark Hang Seng declined 0.8%.

Korea

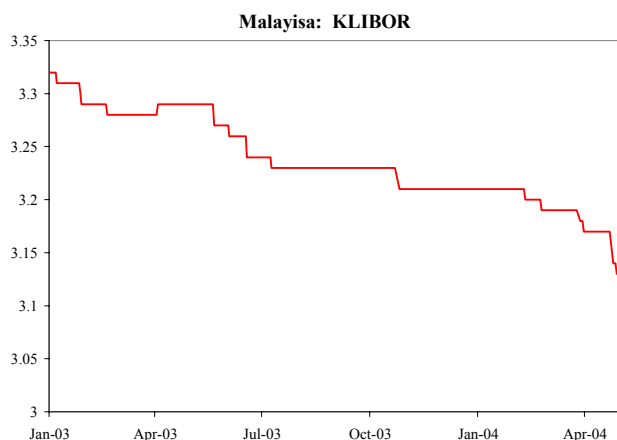
Slowing growth in China may curb export growth the commerce ministry said. Exports of consumer goods will be most affected, it said. Industry analysts were less pessimistic, arguing that, even if growth in China were to slow slightly, it will still provide a huge market for Korean goods. Domestic bonds rose Friday, with the yield in the benchmark 3-year Treasury bond declining 2 bps to 4.42%. **Analysts were impressed by how well local currency bonds held up on a day of heightened risk aversion in emerging markets but they warned this may not continue** if foreign speculative investors—many of whom have long positions in the equity market, financed by short positions in the domestic bond market—decide to exit.



Providing further evidence the financial system is finally coming through the credit card crisis, largest card issuer **LG card returned to profit** for the first time in 6 quarters in Q1. Analysts remain cautious about the sector, pointing out that LG's overdue payments, though down to 15.2% in March, from 19.7% in February, are still three times the levels typically seen in countries with effective credit scoring systems. LG Card lost 6.2% even as the Kospi advanced slightly Friday.

Malaysia

Bank Negara said it would not raise rates, even when the US tightens. Interest rates will be determined by the domestic situation, governor Zeti said. Analysts welcomed the confirmation, pointing out that inflationary pressures are very limited at present. 1-year KLIBOR was unchanged at 3.12% Friday, its lowest rate in several years. The benchmark composite index fell 0.9%, but was down only very slightly on the week. It is has fallen around 8% from its mid-March peak.



Taiwan Province of China

Slowing growth in China will likely reduce export growth, the ministry of finance said, after exports rose a less-than-expected 22.8% yoy in April (March: 17.2% yoy). Analysts calculated the impact would likely be quite limited, perhaps shaving no more than 3 ppts off export growth, according to some.

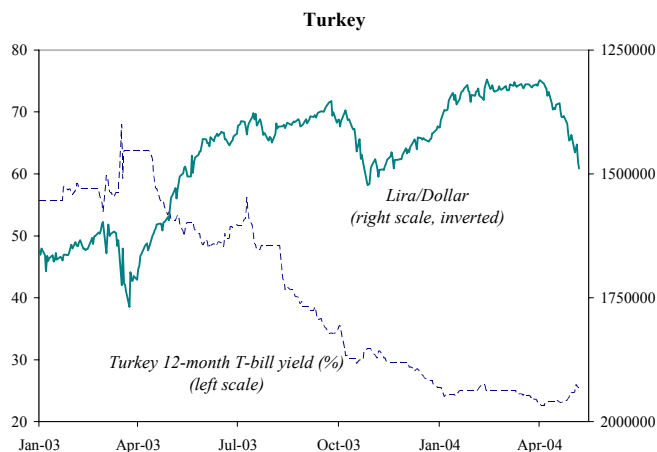
Emerging Europe, Middle East & Africa

Poland

Fitch reduced its ratings for Poland's public debt. The country's foreign debt outlook was reduced from positive to stable at "BBB+", and its long-term local debt rating downgraded from "A+" to "A". Fitch pointed to the political difficulties involved in adopting measures to address, its forecasts of a budget deficit of 7.6% of GDP during 2004, and a general government debt of 53% of GDP at year-end 2004. Financial markets are not responding so far: the zloty was up 0.2% in euro terms so far today, and equities continue to drift down, as they have done for weeks, by 0.2% so far today.

Turkey

Today's source of anxiety in Turkish markets was local political news. Spokesmen for the army protested at a draft law that would change university entrance requirements in favor of graduates of religious schools, saying it was a threat to the secular character of the state. During today's trading, the lira is down 0.3% to 1.484 mn per dollar, after a sharp 2.5% drop in yesterday's trading. The October 2005 benchmark bond was at 27.85% (simple yield), up 65 bps from 27.20% late yesterday. The ISE 30 equity index is down 1.3% so far today.



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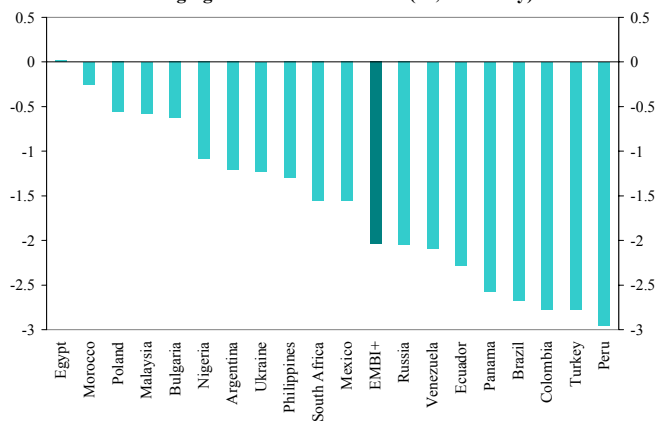
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Interest Rate Fears Bedevil Emerging Bond Markets

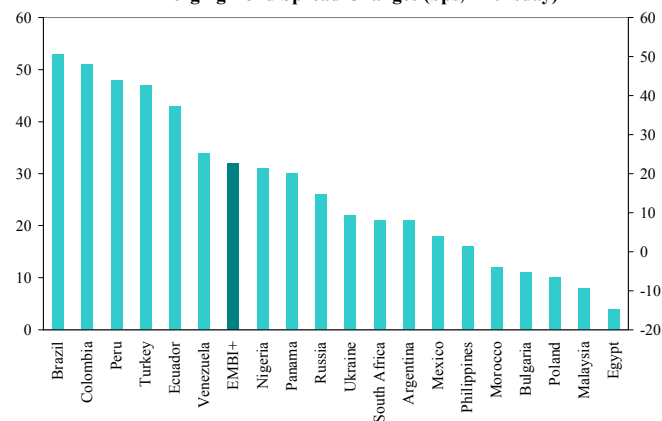
The prospect of rising U.S. interest rates roiled emerging bond markets yesterday. As the marked compression in emerging market bond spreads last year was driven in part by the quest for yield in an environment of abundant liquidity that encouraged carry trades, the eventual removal of monetary stimulus was always expected to result in a significant widening of spreads. The breadth and intensity of yesterday's sell off in the emerging bond market took most by surprise, however. The EMBI+ declined 2 percent, one of the worst daily performances since the height of the Brazilian crisis in August 2002. As most credits suffered losses—including many of the investment grade credits—some investors are now bracing themselves for the possibility of overshooting.

After Tuesday's FOMC statement paved the way for an eventual measured increase in the Fed funds rate, Thursday's better-than-expected release of first-time unemployment claims in the U.S. was met with relative equanimity in the U.S. Treasury bond market. The reaction in the emerging bond market was anything but calm. The extent and intensity of the sell-off in the emerging bond market took many by surprise. Most constituents of the EMBI+ index recorded significant losses. While the high-yielding credits in Latin America bore the brunt of the decline, investment grade credits were also drawn into yesterday's sell-off, including Mexico (-1.6%), Russia (-2%) and South Africa (-1.6%). The EMBI+ has declined almost 6% year-to-date, with Latin America, and especially Brazil (-11%), underperforming.

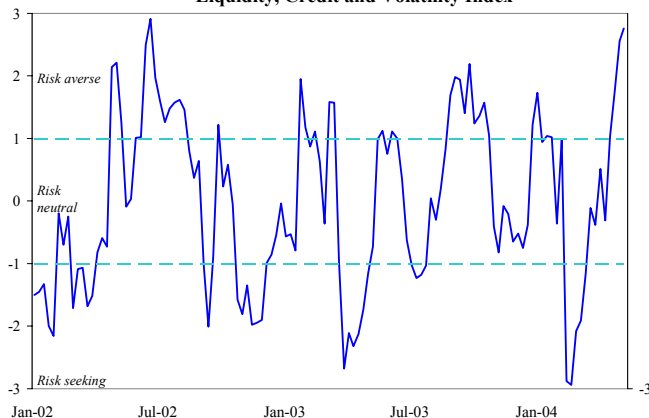
Emerging Bond Market Returns (% , Thursday)



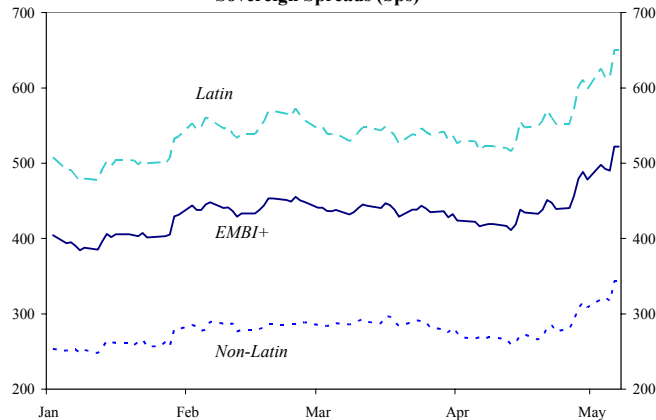
Emerging Bond Spread Changes (bps, Thursday)



Liquidity, Credit and Volatility Index

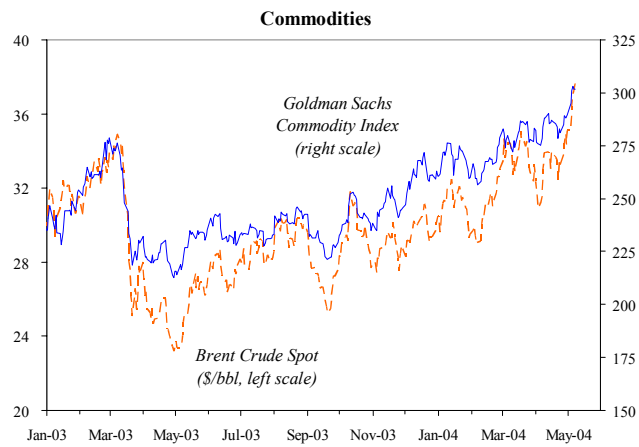
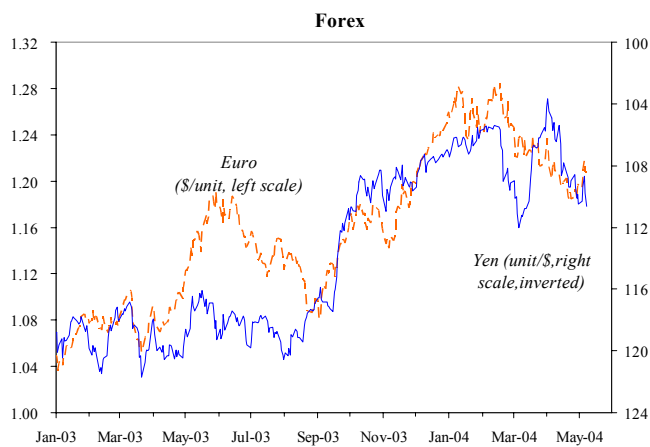
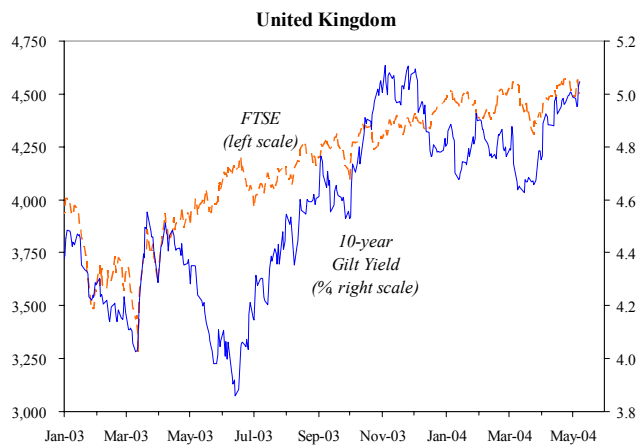
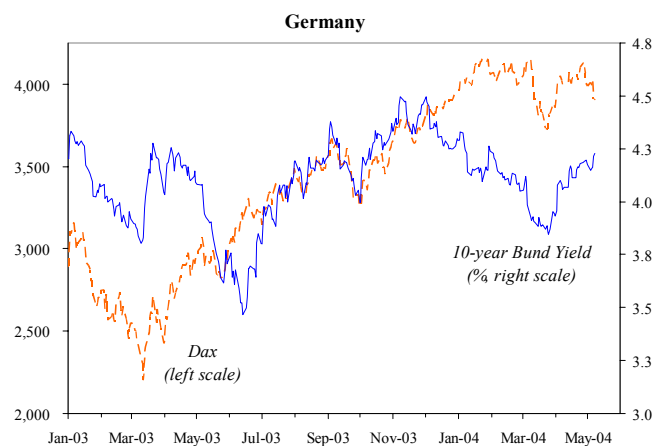
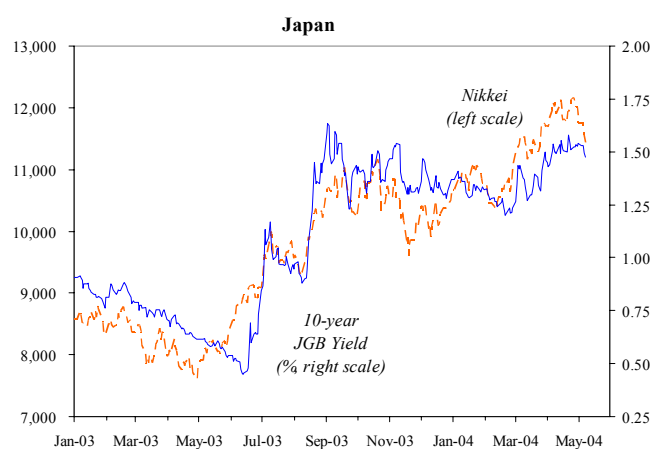
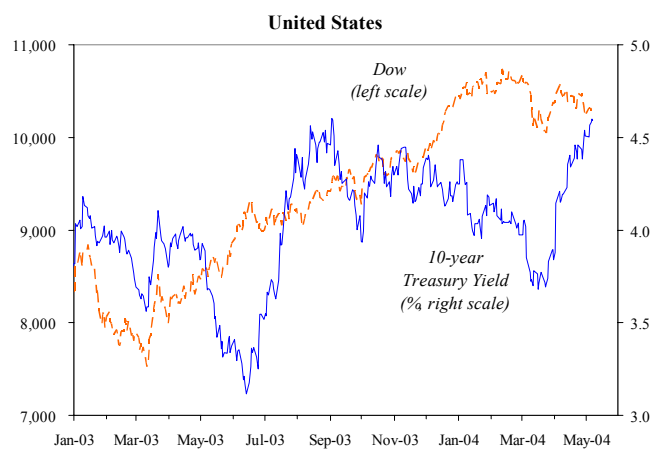


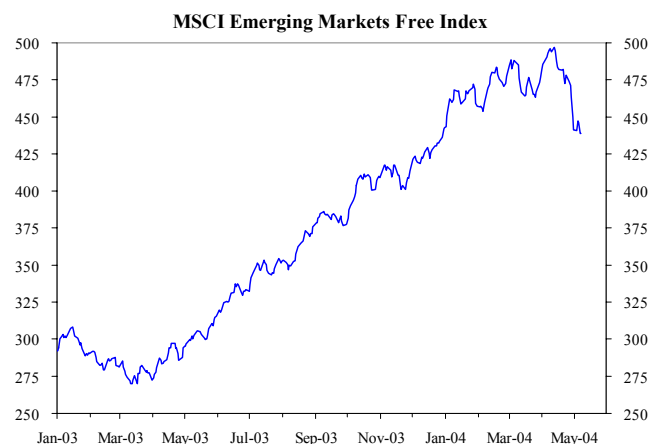
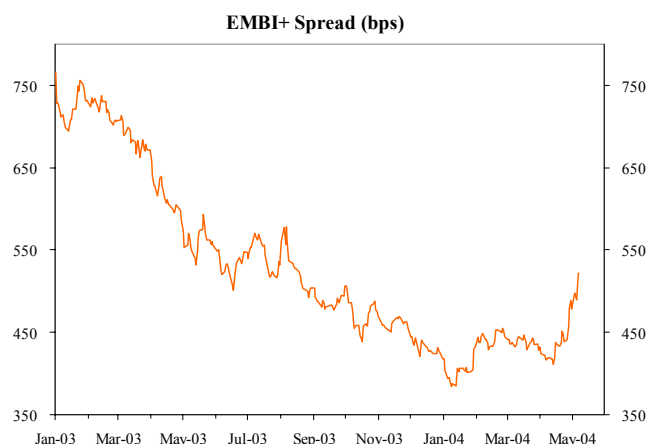
Sovereign Spreads (bps)



Spread widening in emerging bond markets has coincided with a pronounced increase of risk aversion since mid January this year. JP Morgan's Liquidity, Credit and Volatility Index (LCVI)—a widely cited index gauging investor attitude towards risk—has moved decidedly into risk-averse territory, reaching levels last seen during the height of the Brazil crisis in mid-2002. Investment banks confirmed that the selling has been broad based in recent days, with dedicated emerging market investors, crossover investors and trading accounts offloading positions.

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Selected EMBI+ and Benchmark Bond Spreads (bps)

	5/7 trading	5/6 close	Change		5/7 trading	5/6 close	Change		5/7 trading	5/6 close	Change
EMBI+ Composite	521	522	-1	EMBI+ Bulgaria	192	191	1	EMBI+ Malaysia	111	114	-3
EMBI+ Argentina	4692	4718	-26	EMBI+ Morocco	184	184	0	EMBI+ Philippines	452	447	5
EMBI+ Brazil	714	722	-8	EMBI+ Nigeria	719	714	5	MTRC '10 (HK)	79	79	0
EMBI+ Ecuador	945	965	-20	EMBI+ Poland	81	80	1	PSA '05 (Singapore)	71	67	3
EMBI+ Mexico	234	235	-1	EMBI+ Russia	333	332	1	Indonesia '06	n.a.	210	n.a.
EMBI+ Panama	389	390	-1	EMBI+ Turkey	463	443	20	Korea '08	n.a.	96	n.a.
EMBI+ Peru	459	469	-10	Egypt '11	n.a.	93	n.a.	Thailand '07	n.a.	74	n.a.
EMBI+ Venezuela	736	738	-2	South Africa '09	n.a.	136	n.a.				
Colombia '12	n.a.	539	n.a.								

