US: 2013 Macro Strategy

The search for yield continues amid LSAPs

by Ng Weiwen

Products: ETF | CFD | Unit Trusts

21 December 2012
Phillip Securities Research Pte Ltd

- **Index ETFs: (i)SPDR S&P 500 (SPY:NYSE), (ii)SPDR Dow Jones Industrial Average ETF (DIA:NYSE), (iii) Nasdaq PowerShares (QQQ:NASDAQ).**
- **Index CFD (Long/Short): (i) US SP 500 Index USD5 CFD, (ii) Wall Street Index USD1 CFD, (iii) US Tech 100 Index USD5 CFD.**
- **Unit Trusts (US-centric). Bonds: (i) JP Morgan US Aggregate Bond A Acc SGD and (ii) PIMCO GIS Total Return Bond Fd E SGD; Equities: Infinity US 500 Stock Index –SGD; Balanced Fund: Franklin Income Fund A (mdis) SGD H1**
- **Table summary of US Asset Strategy Pg4, with equity sector preference via ETFs Pg 5.**

In 2013, global demand is likely to remain sluggish with G2 economies continuing to deleverage and kick the can (fiscal woes) further down the road. Specifically, US lawmakers will be engaged in a vigorous debate over the details of the fiscal budget compromise while the Eurozone will only just do enough to avoid an escalation of the EZ sovereign debt crisis. Austerity -rather than growth- will be the name of the game for Eurozone, in particular.

Nonetheless, we remain constructive of the investment climate in 2013. Globally, we should see a pick up in growth and financial conditions should remain accommodative on the back of further monetary easing by G4 central banks. Furthermore, *perception* of downside tail risks such as a 'Gre-exit' has receded and negotiations on the US fiscal budget have turned constructive (at the time of this writing). **We think investors should stand ready to shift OWs from fixed income into equities. The cue will come once we see a sustained pick up in yield (correspondingly price decline) in high yield debt, indicative of funds moving out of that space.**

The US will be confronted with three macro themes:

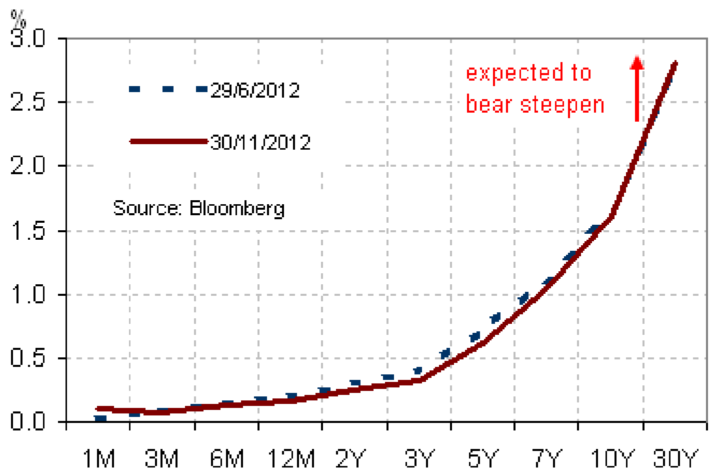
First, modest -but subpar- growth, to the extent of cruising along at stall speed.

- The pace of economic expansion will be sub-trend, weighed down by fiscal withdrawal as well as ongoing deleveraging. While the US private sector continues to deleverage, fiscal consolidation is still in its infancy.
- Housing recovery is going well underway, along with rising consumer confidence but the labour market still remains the weakest link.
- **We expect a strong capex rebound from pent-up demand by businesses once uncertainties over the looming fiscal cliff clears up**.

Second, QEternity. Additional monetary easing (on the back of the Fed's expanded large-scale asset purchase) will continue to buoy markets. The Fed is also likely to remain dovish in 2013 in view of the new incoming voters such as Charles Evans and Eric Rosengren who have previously advocated more aggressive monetary easing to bring down unemployment. Regular dissident of the Fed's loose monetary stance, Jeffrey Lacker is due to be rotated off the voting ranks. Nonetheless, we caution that the impact of QE on equity markets is likely to be subjected to the law of diminishing returns.

Third, fiscal budget negotiations. The downside risk to this is the sharper-than-expected fiscal withdrawal. Post-elections, while one month might be too short to iron out fundamental differences between the Democrats and Republicans, a deal could still possibly be struck by the end of this year on preliminary measures or framework of deficit reduction to avert the cliff, leaving most of the heavy lifting -overhauling the tax code and healthcare entitlement - to 2013.

We expect the US Treasury yield curve to bear steepen, with long-term bond yields rising faster. Though the rise in rates (for the 10y and above) will be capped by sluggish (albeit improving) US economy owing to fiscal withdrawals and lingering uncertainties on the EZ front.



Bond yields (i.e. long-term yields) will rise along with a pick-up in the economy as well as easing of fiscal concerns. Specifically, the US economy is on track for a cyclical recovery (led by the private sector) despite being confronted with structural headwinds (ongoing deleveraging, more so for the public rather than the private sector). Furthermore, rates at the long-end of the yield curve could receive a further boost, especially if the government managed to reach a grand bargain with regard to the fiscal budget negotiations and the fiscal drag tapers off going into 2013.

By contrast, rates at the short-end of the yield curve (short-dated) will be anchored at rather low levels on account of 'QEternity', which will likely continue until the economy (particularly the labour market) improves substantially. Furthermore, with unemployment rate unlikely to come down to 6.5% till 2015, yields of short-dated bonds will likely remain depressed for now.

The search for yield still goes on, especially after the December FOMC.

Consistent with our expectations (in our morning note), the Fed indicated that asset purchases will continue (to the tune of US$85bn/mth) even after Operation Twist expires by the end of this year, with the asset mix as US$40bn in MBS and US$45bn in Treasuries (unsterilised and long-dated) per month until there is substantial improvement in the labour market. By supporting the mortgage market and maintaining downward pressure on long-term interest rates, these asset purchases will ensure financial conditions remain accommodative.

Importantly, note that there was no calendar guidance (of maintaining low rates "at least through mid-2015") in the latest FOMC statement. Instead, the Fed is now using numerical thresholds (Evans Rule) to guide monetary policy. Specifically, the Fed is likely to maintain rates near zero as long as :(i) unemployment rate remains above 6.5%, (ii) 1-2yr ahead inflation ahead outlook does not rise above 2.5% (i.e. 0.5%-pt above the Fed's 2% long-run goal) and (iii) long-run inflation expectations does not unhinge. Should these numerical thresholds be breached, we will likely see our first rate hike (from near zero rates).

Nonetheless, based on the Fed's latest economic projections, unemployment is unlikely to reach 6.5% at least till around mid-2015 -consistent with the Fed's earlier guidance. **Till then, the search for yield continues amid a low growth, low inflation environment.**

Fixed Income

And the search will extend beyond Treasuries (which is over-crowded) and MBS - two spaces which are increasingly dominated by the Fed -with its aggressive asset purchases ($45bn Treasuries, $40bn MBS). Specifically, there is little upside to Treasuries which are highly sensitive to interest rate hikes, which translates to a poor reward-risk ratio.

We have low conviction on US treasuries owing to central banks worldwide writing 'put options', providing little incentive for investors to own Treasuries. While we expect bond yields to climb, the rise will be incremental/ gradual rather than a sharp one. This takes into account (i) accommodative monetary policy which is set to continue and (ii) limited supply of safe haven assets available.

While corporate as well as high yield debt should continue to outperform, returns will be significantly lower in view of limited price appreciation. Instead, higher coupons will be the main source of return now.

Corporate debt remained attractive in view of improved fundamentals as well as relatively low (i.e. below average) default rate particularly in the high yield universe. Mortgage-backed securities should still receive support from the Fed's continued purchases of MBS as well as an improving housing market.

The shortlist of possible US fixed income plays include:
(i) iShares iBoxx Investment Grade Corporate Bond Fund
(ii) iShares iBoxx $ High Yield Corporate Bond Fund
(iii) Mortgage-Backed Securities

While we maintain OW on Mortgage-backed Securities (MBS), we wish to point out that there might be limited upside to prices of MBS ETFs on account of the following: (i) After Bernanke singled out the weak housing market as an obstacle to growth in Jan 2012, markets have been expecting future monetary easing to take the form of MBS purchases prior to Sept QE3. Thus, most of the expectations have been priced in prior to Sept (ii) While the Fed has committed to purchase MBS to the tune of US$40b/mth till the labour market improves substantially, the Fed does not set the mortgage rate and is just one of the players (albeit a significant one) in the mortgage market

Apart from fixed income, investors might consider the following bond-like equity ETFs that offer attractive dividend yields :
(i) iShares Dow Jones Select Dividend Index Fund (DVY: NYSE) (~3.7% Div Yield)
(ii) iShares S&P U.S. Preferred Stock Index Fund (PFF: NYSE) (~ 5.8% Div Yield)

One of our preferred trades is long positions in iShares S&P U.S. Preferred Stock Index Fund (PFF: NYSE). With equity risk premium likely at multi-decade high, we would have an inclination for equities. But equities as an asset class is still confronted with lingering fiscal uncertainties. **Still, a long position in iShares S&P U.S. Preferred Stock Index Fund (holdings comprise of Diversified financials: 40%, Banks: 25%) is in line with our OW on financials and will allow investors to gather a decent annual dividend yield of around 6% (monthly distribution).**

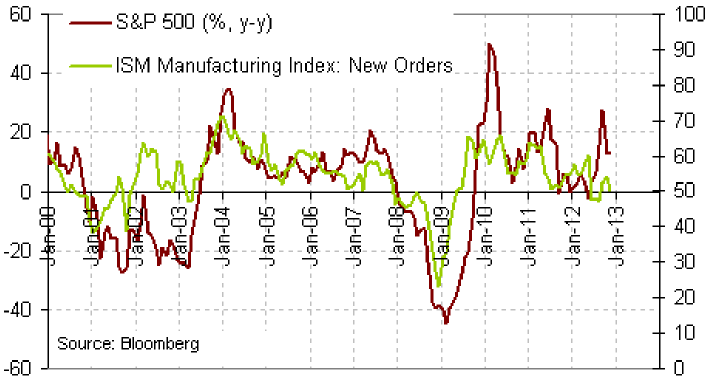
On balance, low yields in US make fixed income elsewhere (particularly emerging markets) more attractive, especially with risk appetite returning. On account of favourable external balances, monetary policy rates, fiscal stability, foreign exchange rates as well as yields, we recommend EM Asia local currency bonds.

Equities

With bond yields in DM and EM trending down, global yields will likely rebound once an inflection point is reached in view of improved global macro backdrop. Rising bond yields typically mean equity returns tend to be higher than bond returns.

Nonetheless, we are still are neutral on US equities on absolute terms but upgrade it to marketweight on relative terms.

Sluggish ISM manufacturing new orders (forward-looking indicator) portend lackluster outlook for the S&P500 - for now. But this could quickly reverse to a positive tone (leading us to be constructive on equities) once fiscal uncertainties are resolved.



Our upgrade to MW on relative returns for US equities takes into account the following:

- a resolution to the fiscal uncertainties will provide clarity to aid business' investment decisions and restore market's confidence
- global liquidity glut with G4 central banks in a quantitative easing mode will buoy equities
- improving global macro backdrop (with China's emphasis on expansionary fiscal policy to support growth) and receding tail risks of a EZ break up (particularly Gre-exit)
- In view of a low interest rate environment as well as falling corporate yields, corporates are able to refinance at lower rates when rolling over their debt.

However, we caution that the following might still weigh on US equities:

- Inflation expectations (rather than inflation per se) might result in equities to be de-rated, resulting in PE contraction.
- Obama's proposal for taxes on capital gains as well as dividends dulls the case for equities. Some might even pare down their equity holdings before the tax changes occur, though the reduction would be minimal as investors would want to capitalise on the big rally should we see a resolution to the fiscal cliff before year end.

Our preferred sectors are still **Healthcare (XLV)**, **Financials (XLF) and Homebuilders (XHB)**. We like Healthcare- especially with greater certainty over the Affordable Care Act; Financials and Homebuilders on account of an improving housing market. We upgraded Industrials (XLI) from low conviction to neutral in view of improved global manufacturing activity.

We also highlighted (i) Downsides to our "Preferred" call on Financials (ii) Upsides to our "Neutral" call on Technology (XLK).

For Financials (XLF), the sector will be confronted with headwinds from (i) yield curve bear steepening (which has been a negative for financials), (ii) downward pressure on net interest margins (NIMs), especially with more quantitative easing (weighing on long-term yields) and (iii) regulations (uncertainties over Basel III and Dodd- Frank Bill, with the latter likely to be implemented more quickly post-elections)

For Technology (XLK), the sector will likely remain in a soft patch until we see greater clarity on the fiscal front. Nonetheless, the tech sector has rather robust fundamentals with its strong balance sheets as well as large cash balances. We wish to highlight that the tech sector is likely receive a boost from a potential boost in technology spending (in equipment and software) in a broader productivity push when companies ramp up capital spending amid accommodative monetary conditions, especially after uncertainties over the fiscal cliff clear up. In such an event, we might revisit our rating on tech with an upgrade to OW.

Currencies

From a medium-term horizon, the USD will hold its ground against the EUR as well as the JPY. Apart from growth differentials (which favour the US compared to Europe & Japan), Europe is still mired with structural challenges possibly warranting further monetary easing ahead and JPY will be subjected to downward pressure (with the ruling LDP being vocal about aggressive monetary easing). However, any upside in USD will be tempered by the Fed's QEternity. Against most Asian currencies (buoyed by excellent macro fundamentals and external balances), we expect the USD to come in a tad weaker.

Summary of Our US Cross Asset Views

* Absolute Return: BL = Bullish ; N = Neutral ; BR = Bearish

* Relative Return: OW = Overweight ; MW = Neutralweight ; UW = Underweight

	Absolute Return/ Relative Return	Last Price (US$)	3 Month Total Return (%)	YTD Total Return (%)	Dividend Yield (%)	Dividend Freq
Treasuries						
iShares Barclays TIPS Bond Fund	N/OW	121.64	0.54	6.50	2.21	Monthly
iShares Barclays 10-20 Year Treasury Bond Fund	N/UW	134.67	0.83	3.21	2.24	Monthly
iShares Barclays 20+ Year Treasury Bond Fund	N/UW	120.91	0.79	1.84	2.78	Monthly
Mortgage-Backed Securities						
Vanguard Mortgage-Backed Securities ETF	BL/OW	52.45	-0.60	2.11	1.69	Monthly
SPDR Barclays Capital Mortgage Backed Bond ETF	BL/OW	27.74	-0.57	1.88	2.71	Monthly
Corporate Bonds						
iShares iBoxx Investment Grade Corporate Bond Fund	N/MW	120.91	0.90	9.75	3.86	Monthly
iShares iBoxx $ High Yield Corporate Bond Fund	BL/OW	93.57	1.43	11.44	6.62	Monthly
Vanguard Long-Term Corporate Bond ETF	N/MW	91.32	0.51	9.40	4.35	Monthly
Index ETFs						
SPDR S&P 500 ETF Trust	N/MW	144.29	-0.32	17.56	1.98	Quarter
SPDR Dow Jones Industrial Average ETF Trust	N/MW	132.62	-0.92	12.09	2.45	Monthly
Powershares QQQ Trust Series	N/MW	66.26	-5.03	20.01	0.93	Quarter
Dividend-play Equities						
iShares Dow Jones Select Dividend Index Fund	-	57.82	1.54	12.13	3.67	Quarter
iShares S&P US Preferred Stock Index Fund*	-	39.71	0.67	17.43	5.81	Monthly

* one of our preferred trades

Source: Bloomberg, data as at close of 19 December 2012 US trading session

Summary of Our US Equity Sector Views (See Pg 7-8 for details)

	Ticker	Last Price (US$)	3 Month Total Return (%)	YTD Total Return (%)	Dividend Yield (%)	Dividend Freq
Prefer						
Health Care Select Sector SPDR Fund	XLV	40.71	3.31	20.45	1.90	Quarter
Financial Select Sector SPDR Fund	XLF	16.47	3.67	29.01	1.60	Quarter
SPDR S&P Homebuilders ETF*	XHB	26.77	6.77	58.57	0.84	Quarter
Neutral						
Technology Select Sector SPDR Fund	XLK	29.32	-6.44	17.09	1.51	Quarter
Consumer Staples Select Sector SPDR Fund	XLP	35.67	0.57	13.04	2.67	Quarter
Consumer Discretionary Select Sector SPDR Fund	XLY	47.91	2.36	24.90	1.41	Quarter
Energy Select Sector SPDR Fund	XLE	72.69	-2.56	7.26	1.66	Quarter
Industrial Select Sector SPDR Fund^	XLI	38.25	2.98	15.77	2.09	Quarter
Low Conviction						
Materials Select Sector SPDR Fund	XLB	37.3	-0.01	13.44	2.01	Quarter
Utilities Select Sector SPDR Fund	XLU	35.73	0.50	3.00	4.01	Quarter

* not a sector fund but one of our preferred ETFs
^ Upgrade Industrials from Low Conviction (in our Oct US Macro Strat) to Neutral
Source: Bloomberg, data as at close of 19 December 2012 US trading session

Regional Valuations - Compared to the MSCI world and most regions, US is slightly more expensive based on P/B metric.

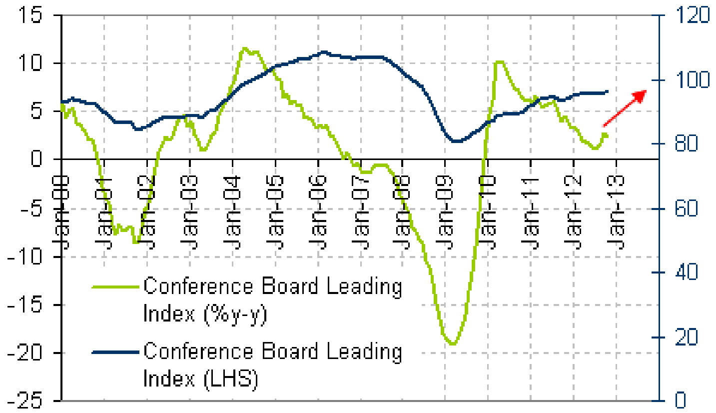
	Index	T4Q P/E (x)	F4Q PE (x)	P/BV (x)	Dividend Yield (%)	Return on Equity (%)	Total Return_Ytd (%)
MSCI World Index	1348.9	16.2	13.8	1.8	2.8	20.9	17.3
MSCI United States Index	1370.9	14.8	14.0	2.2	2.2	25.4	17.8
MSCI Europe Index	97.0	17.7	12.5	1.6	3.8	18.6	18.2
MSCI AC Asia Pacific	129.4	16.6	14.7	1.4	2.7	14.1	15.7
MSCI AC Asia Pacific Excluding Japan	465.7	13.6	13.3	1.7	3.0	17.9	22.3
MSCI South East Asia	866.1	14.1	14.9	2.1	3.0	26.5	21.6
MSCI China Index	62.7	11.0	11.0	1.7	2.9	18.8	22.4

Source: Bloomberg, PSR est. Data as at close of Asia trading session, 19 Dec 2012.

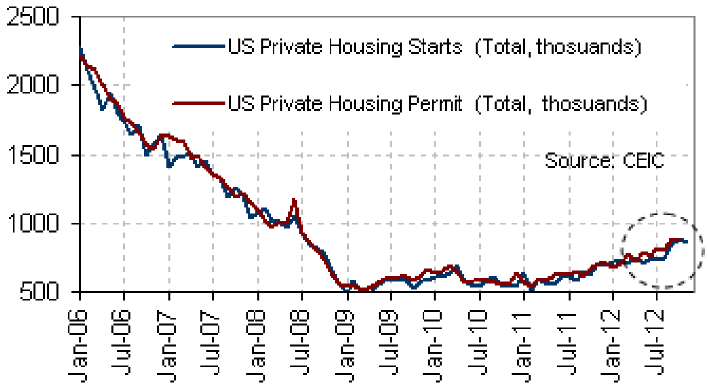
MACRO OUTLOOK

- We expect modest -but subpar- growth for the driven by the private sector as well as the housing recovery. However, growth will be hampered by the fiscal drag.

Green shoots in the US economy according to the Conference Board Lead indicator.



Housing market recovery is gaining traction, especially with the rise in housing permits (a proxy for future construction). This housing rebound -given a strong boost by QE3 (with its focus on purchases of MBS) - has positive multiplier effects across the economy.

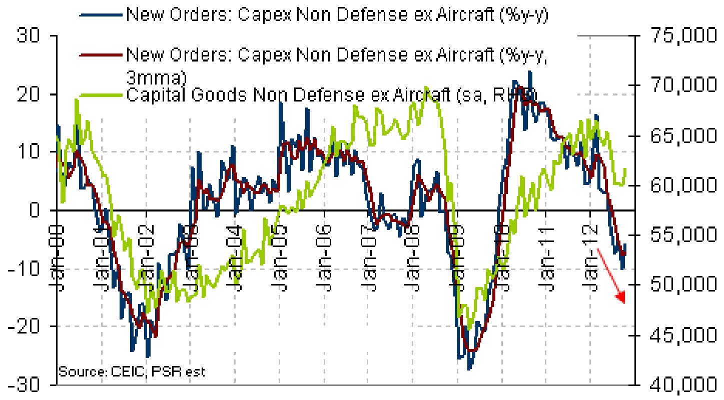


- Consumer confidence has been broadly buoyant. A rise in disposable income (on the back of a pick up in household wealth) as well as a gradual labour market recovery will lend support to consumer spending, counteracting the fiscal drag from possibly higher payroll taxes at the turn of the year.

- However, uncertainties on the US fiscal front persist and are weighing on business sentiment as well as capex spending.

- While we expect a short-term agreement to clear the immediate hurdle of averting the cliff by the end of this year, most of the heavy-lifting on entitlement reform will probably only take place next year. Till then, any boost to business confidence is likely to be transitory at best.

At this juncture, uncertainties on the looming fiscal cliff continue to weigh on capex. Small business sentiment is also adversely affected by the looming fiscal cliff with concerns on taxation being viewed as the top issue restraining investment.

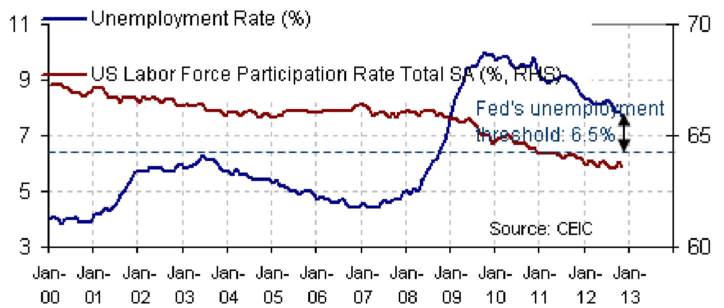


- Energy production will increase with continued shale gas/oil exploration as well as extraction. This will help reduce energy imports and consequently improve the US trade balance. Furthermore, with natural gas prices declining, this would translate to cost savings across the industries.

- Noteworthy, US has relative competitive advantage (compared to other nations) in the exploration and mining of shale energy (a game changer) with its availability of geological data and private ownership of underground gas (which would allow profit maximising to skirt environmental issues) with massive deposits of shale deposits which could be accessed through fracking.

- **Notwithstanding accommodative monetary policies, ongoing deleveraging (particularly in the financial sector) has put a lid on the velocity of credit and money. Thus, stable inflation expectations provide room for the Fed to continue to pursue greater monetary easing to bring down unemployment from elevated levels.**

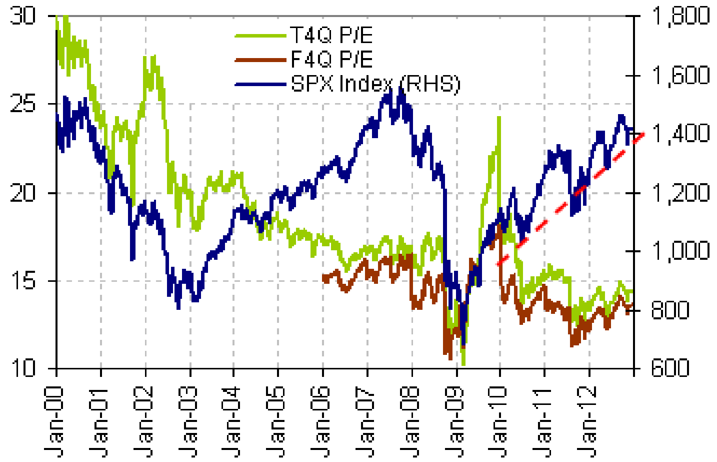
Unemployment has also remained elevated with jobs simply not created fast enough. Increasingly, frustrated job seekers have given up looking for a job, which translated to a declining labour force participation rate.



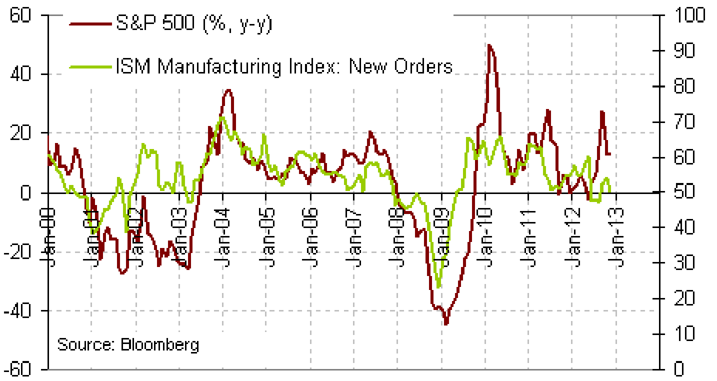
- **We expect real GDP growth to come in at around 2.2% in 2012 and 2013**, barring downside risks. **Consumer price inflation is expected to rise around 2.1% in 2012 and 2% in 2013. PCE Deflator** - the Fed's preferred gauge of inflationary pressures- **is expected to rise 1.8% in 2012 and 2013.** Still, we think that there are upsides to the 2013 inflation forecast, especially if inflationary expectations come unhinged and commodity prices surge (on the back of speculative demand, geopolitical tensions, stronger-than-expected recovery in global demand).

EQUITIES

Valuations are distorted by continued quantitative easing (large scale asset purchases). F4Q P/E is trading in a range.



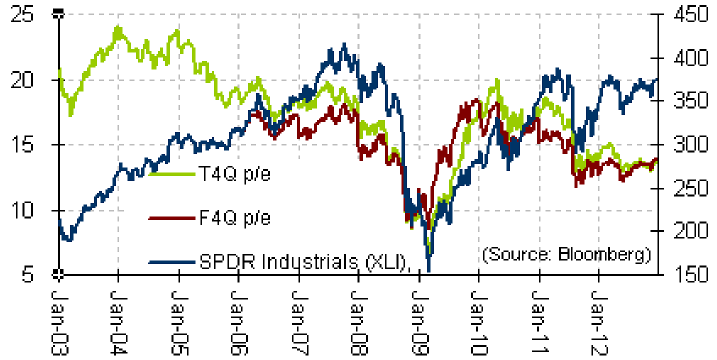
Sluggish ISM manufacturing new orders (forward-looking indicator) portend lackluster outlook for the S&P500. But this could quickly reverse to a positive tone (leading us to be constructive on equities) once fiscal uncertainties are resolved.

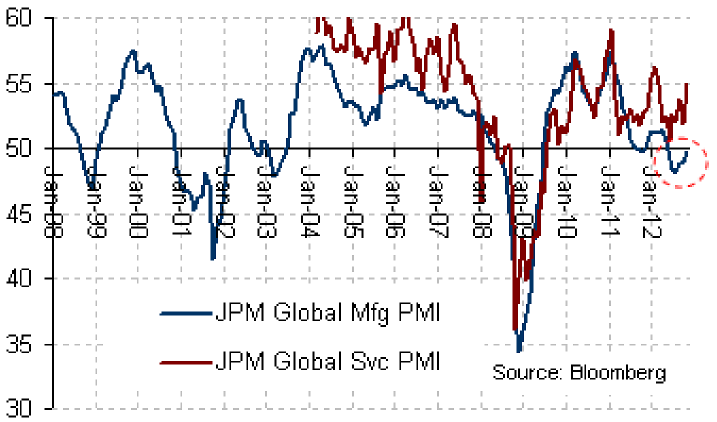


- As we continue to see-saw between a risk-on and risk-off environment in the year ahead, it might be apt to adopt a strategy which combines both dividend yield and earnings growth, that will intuitively give you better risk-adjusted returns. This takes into account an environment with accommodative monetary policy (low interest rates) as well as elevated macro uncertainties.

- **We are upgrading Industrials from UW to MW** and maintaining our preference for most equity sectors. Please refer to our table summary of US equity sector views.

- **Industrials (XLI).** The upgrade in Industrials take into account the expected improvement in manufacturing activity in the months ahead -as reflected by forward-looking indexes such as the JPM Global manufacturing PMI as well as the US ISM index. Furthermore, a rebound in the Chinese economy is likely to buoy machinery stocks.





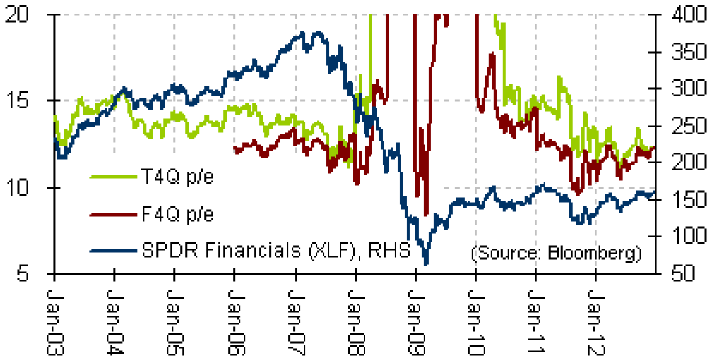
- We also wish to highlight the following:

  - **Downsides to our "Overweight" call on Financials**
  - **Upsides to our "Neutral" call on Technology**

- **Financials (XLF). The financial sector will be confronted with headwinds from (i) yield curve bear steepening (which has been a negative for financials), (ii) downward pressure on net interest margins (NIMs), especially with more quantitative easing (weighing on long-term yields) and (iii) regulations (uncertainties over Basel III and Dodd-Frank Bill, with the latter likely to be implemented more quickly post-elections)**

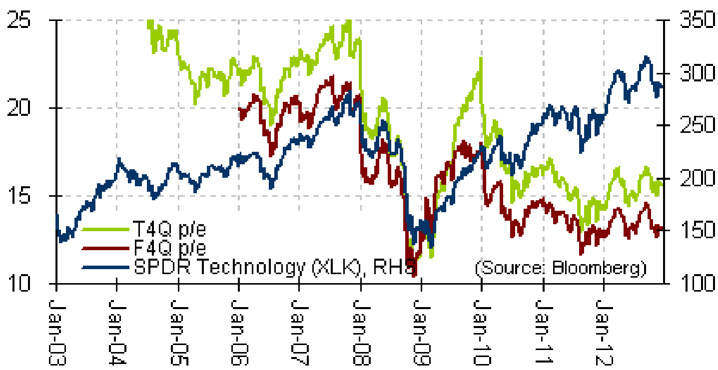
- Nonetheless, on balance, we are cautiously optimistic that financials could benefit from a generous spread between the relatively higher rates they lend out to corporates and the rock bottom rates they borrow from the Fed. Furthermore, with the housing market showing signs of turning around the corner and mortgage rates falling, banks could benefit from a resurgence in mortgage demand and rid foreclosed properties from their balance sheets.

- **However, should the financial sector succumb to these headwinds, we will stand ready to downgrade the financial sector.**



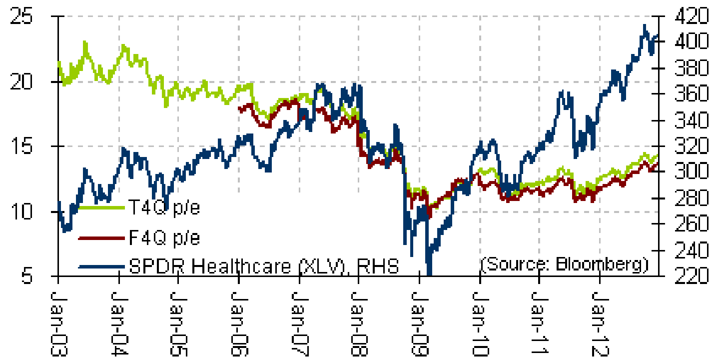
- **Technology (XLK).** In the near term, tech will likely remain in a soft patch until we see greater clarity on the fiscal front. The recent pullback in Tech was largely due to disappointing earnings from major tech heavyweights such as IBM, Microsoft, Intel as well as Google.

- Nonetheless, the tech sector has rather robust fundamentals with its strong balance sheets as well as large cash balances. We wish to highlight that the tech sector is likely receive a boost from a potential uptick in technology spending (in equipment and software) in a broader productivity push when companies ramp up capital spending amid accommodative monetary conditions, especially after uncertainties over the fiscal cliff clear up. **In such an event, we might revisit our rating on tech with an upgrade to OW**.



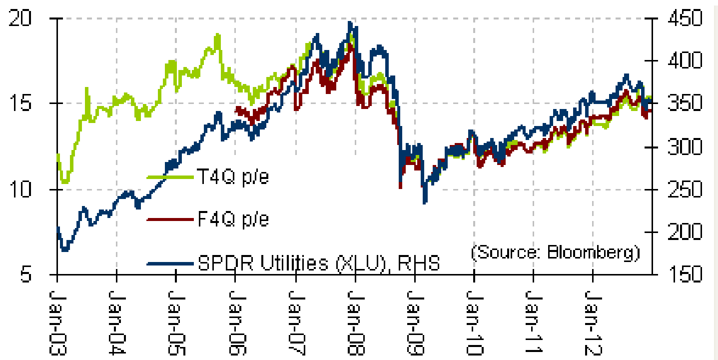
- **Our preferred sectors** (apart from Finance which was highlighted earlier) are as follows:

- **Healthcare (XLV)**. We like healthcare especially after greater certainty over the Affordable Care Act which has been ruled constitutional and would be extended to millions of Americans who would otherwise be uninsured. Furthermore, valuations are still below the historical average of T4Q P/E +20x. However, we caution that in US fiscal consolidation plans, healthcare (particularly medicare) spending could be slashed, dulling the allure of the sector.



- **Homebuilders (XHB)** should continue to benefit as the recovery in the housing market continues to gain traction.

- **We have low conviction for Utilities (XLU).** Though utilities offer the highest dividend yield amongst the sectors, an increase in taxes on dividend income dull the allure of the utilities segment. With market chasing yields for some time, valuations have been overstretched. Furthermore, if the economy does rebound and risk appetite improves, utilities - a defensive sector- would take a beating. Conversely though, if uncertainties over the looming fiscal cliff as well as EZ sovereign crisis rise, defensives such as utilities could enjoy further upsides- though it is likely to be limited.



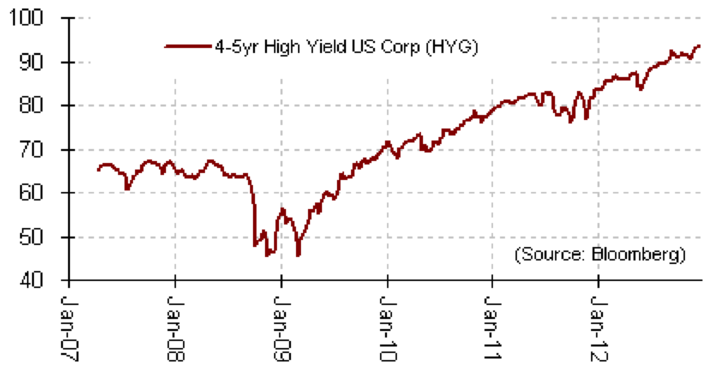
- Please see our US Macro Strategy Report, 24 Oct 2012 for details on our sector views.

FIXED INCOME

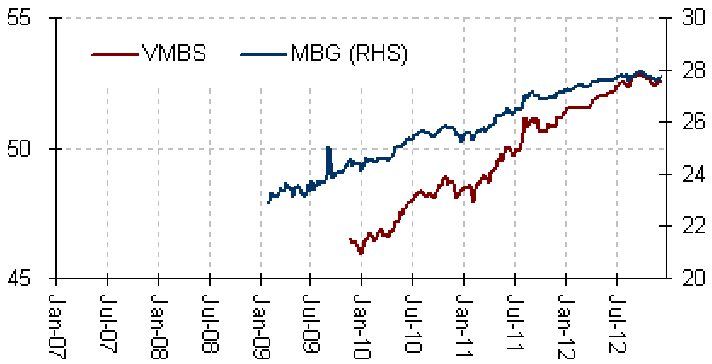
- Global risk on or risk off, portfolios will have to explore beyond traditional safe havens - which yield too low to protect purchasing power and have doubtful credit ratings. We reiterate our main investment theme, which is long EM/Asia Debt (**Asia Bond ETFs: N6M:SGX, N6L:SGX, O9P:SGX | EM Bond ETFs: EMB:NYSE, LEMB:NYSE, EMHY:NYSE**) –EM nations on the other hand have nominal GDPs compounding faster than debt and +3.5% yields to boot, and are likely to increasingly feature as core-fixed income holdings. Interestingly both US$ and LC denominations are on strong uptrends as US$ portfolios diversify their US$ holdings to include EM/Asia.

- On the back of monetary easing by G4 central banks (Fed, ECB, BoJ, BoE), we expect interest rates to remain low for a considerable period. Such environment will drive investors' appetite for yield plays. What are some opportunities in the US market?

- On the fixed-income asset class, we are **OW high-yield US corporate bonds** (ETF: **HYG:NYSE**) as US$ portfolios move out of treasuries and investment grade corporate to trudge further along the risk spectrum in search of yield.



- We are also **OW Mortgage Backed Securities** (ETF: **VMBS, MBG**) - the Fed is going to buy this at US$40b/mth indefinitely until the economy rebounds and the labour market outlook improves substantially – which on the Fed's definition of around 6.5% unemployment could take a while.



- Long **Treasury inflation-protected securities** (ETF:**TIP**). Portfolios are loading up TIPs as inflation insurance in view of the open-ended nature of the LSAP (of MBS and Treasuries).

To replace the expiring Operation Twist, the Fed will be continuing to buy $45 bn of Treasuries, with the focus of purchases at the long end of the yield curve. In particular, the Fed is maintaining its focus on the long end of the yield curve (Treasuries with remaining maturities of 20 -30 years). In a departure from Operation Twist Operations, the Fed is targeting Treasuries with maturity of 4 - 6yrs this time round, allocating around 20% of its purchases.

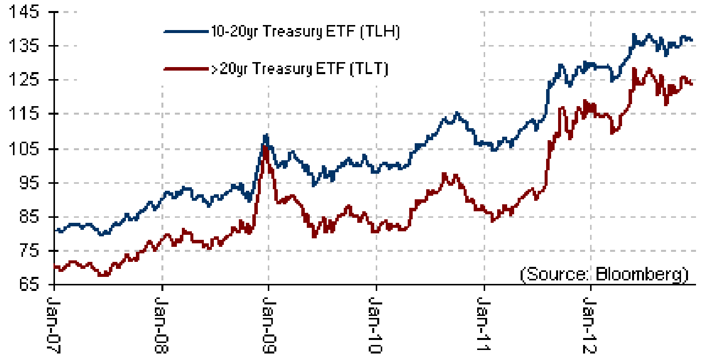
	Approx. Weights
Treasuries	
4 – 4¾ Years	11%
4¾ – 5¾ Years	12%
5¾ – 7 Years	16%
7 – 10 Years	29%
10 – 20 Years	2%
20 – 30 Years	27%
TIPS	
4 – 30 Years	3%

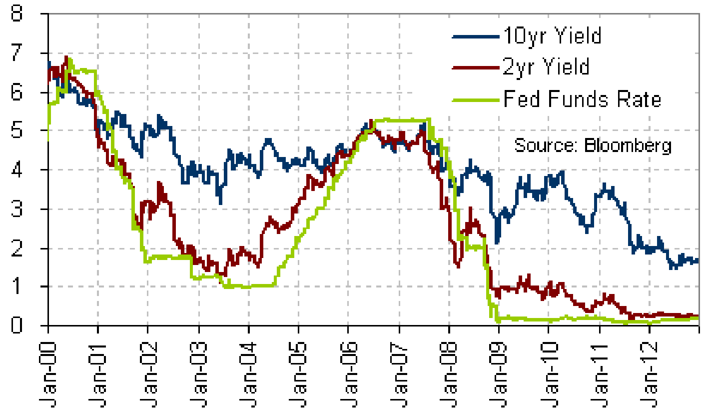
Source: New York Fed

- Furthermore, this round of Treasuries purchases will be **unsterilised** as the Fed is running out of short-term securities to sell. Thus, effectively boosting the monetary base, with an additional $40bn of MBS/mth to boot. **The risk is this expansion in asset purchase could be inflationary, unhinging inflation expectations**.

- We expect the Treasury space will get increasingly crowded. With a smaller supply of US Treasuries, competition among the usual players -the Fed, funds, foreign demand- should intensify.

- Thus, we are **UW US Treasuries** (ETFs: **TLH:NYSE, TLT:NYSE**) and MW US Investment Grade Credit (ETFs: **VCLT:NYSE** and **LQD:NYSE**). US Treasuries took a beating with the QE3-OMT inducing risk-on appetite. Furthermore, treasuries are not the primary target of the Fed's QE3. We have low conviction on treasuries and so underweight them. But we caution in view of the fiscal challenges ahead for the G2 economies, the mood could easily swing to risk-off mode and we will see once again safe-haven flows into the Treasuries.


10-20yr Treasury ETF (TLH)
>20yr Treasury ETF (TLT)
(Source: Bloomberg)
145
135
125
115
105
95
85
75
65
Jan-07
Jan-08
Jan-09
Jan-10
Jan-11
Jan-12


10yr Yield
2yr Yield
Fed Funds Rate
Source: Bloomberg
8
7
6
5
4
3
2
1
0
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08
Jan-09
Jan-10
Jan-11
Jan-12

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