

Major Developments:

Tuesday, February 16:

- UK Consumer Price Index (CPI) falls from 0.6% to -0.2%, m.o.m.
- US Empire State Manufacturing Survey rises from 15.92 to 24.91

Wednesday, February 17:

- Bank of Japan (BoJ) leaves target rate unchanged at 0.10%
- US housing starts rise from 557,000 to 591,000 units, annualized

Thursday, February 18:

- US Producer Price Index (PPI) rises from 0.2% to 1.4%, m.o.m.
- US initial jobless claims rise from 440,000 to 473,000

Friday, February 19:

- Germany producer prices rise from -0.1% to 0.8%, m.o.m.
- US CPI rises from 0.1% to 0.2%, m.o.m.

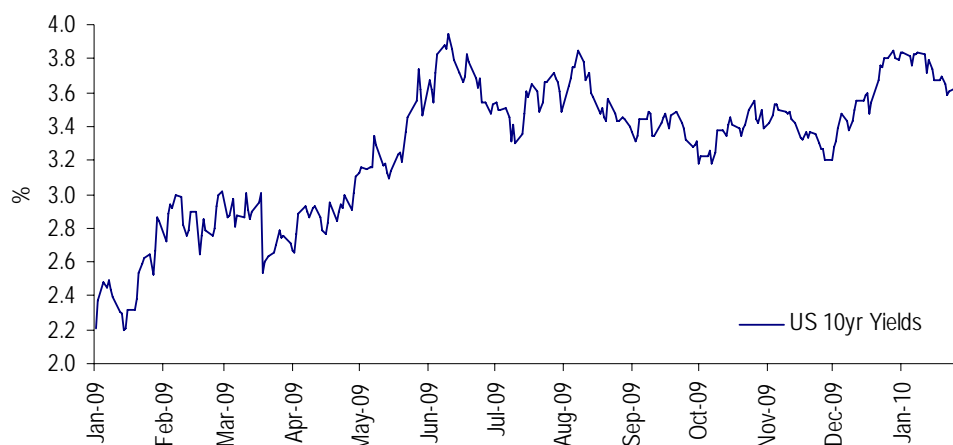
Since our last Commentary, market confidence has improved significantly. The S&P 500 has rallied from about 1060 at the close on February 8 to around 1100 today, an increase in excess of 3% in just two weeks. Similarly, the benchmark US 10-year Treasury bond yield has risen over the same period from about 3.6% to 3.8%. The primary driver of the turn around in sentiment was the EU showing support for Greece. The latter's fiscal problems have recently provoked both concerns that other peripheral European countries have, or may have, similar difficulties and worries that the problem is potentially endemic in the developed world, including the UK and even the US. As we have written in this space, we have regarded the fiscal problems as serious, but have expected and continue to expect solutions that will be acceptable to the market.

In the case of Greece, many European leaders have made clear in the past few weeks their support for Greece, clarifying that it should be resolvable within the EU, and that IMF support is not needed. This has cheered markets, driving the improvement in broad sentiment already mentioned. Simultaneously, it remains true that there has been no specific proposal for Greece, no specific numbers for what fiscal adjustment is required by the EU or acceptable to Greece. Thus, uncertainty will continue. But we do agree with the market insofar as it was pricing in an excessive amount of concern that there would be no solution.

Recent developments in the UK, however, are worth highlighting: last week the public finance deficit was around twice as high as the market expected, while the conservative party lead in the polls has been nearly halved. Thus, prospects for a hung Parliament loom large just when the government needs uniformity around a solution to tackle its fiscal problems. Again, we remain optimistic that a solution will be found in the long-term, but in the short-term we expect continued volatility.

Meanwhile, in the United States, economic data has emerged broadly better-than-expected, while corporate earnings have largely beat expectations, supporting markets worried about too-slow growth. And the surprise hike in the Federal Reserve's discount rate (from 0.50% to 0.75%) seems to have been digested. The move came between FOMC meetings, and at an odd time of day (late in the afternoon)—thus initially spooking markets into thinking that it was a precursor to more aggressive rate hikes. But Chairman Bernanke's semi-annual testimony to Congress this week may have been a factor in the timing, allowing him to signal that the Federal Reserve continues to remove "policy accommodation" by continuing to unwind some of the more dramatic measures introduced in late 2008. We continue to believe that while the various quantitative easing measures will fade over the year, the Federal Reserve will be cautious about initiating hikes in interest rates.

Chart of the Week: The 10-Year US Treasury Bond Yield



Source: Bloomberg

Next Week:

Tuesday, February 23:

- France's CPI is expected to fall from 0.3% to -0.3%, m.o.m.
- US consumer confidence is expected to fall from 55.9 to 55.0, m.o.m.

Wednesday, February 24:

- US new home sales are expected to rise from 342,000 to 355,000 units, annualized

Thursday, February 25:

- Japan's national CPI expected to rise from -1.7% to -1.4%, y.o.y.
- US House Price Index expected to fall from 0.7% to 0.4%, m.o.m.

Friday, February 26:

- UK GDP is expected to rise from 0.1% to 0.2%, q.o.q.
- US GDP is expected to remain unchanged at 5.7%, q.o.q.
- University of Michigan Consumer Sentiment Index is expected to rise from 73.7 to 74.0, m.o.m.
- US existing home sales are expected to rise from 5.45 million to 5.50 million units, annualized

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on March 2010 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0 - 0.25%	0.28%	March 16
ECB	-25 bps	May 7, 2009	1.00%	0.68%	March 4
BoJ	-20 bps	December 18, 2008	0.10%	0.44%	March 16
BoE	-50 bps	March 5, 2009	0.50%	0.68%	March 4

Market Review: Sovereign Bond Markets

United States

The Treasury market had a quiet start to the holiday-shortened week, although the lack of negative news on Greece and a rebound in major equity markets weighed on Treasuries by week's end. Thursday's unexpected 25 basis point increase in the discount window rate sparked a knee-jerk sell-off, particularly in shorter-dated maturities. While Federal Reserve officials subsequently reiterated that the policy rate would likely stay low for an "extended period", discussions about the bank's exit strategy and the removal of other accommodative measures increased. Additionally, next week's Treasury supply—US\$44 billion in two-year notes, US\$42 billion in five-year notes, and US\$32 billion in seven-year notes, as well as US\$8 billion in 30-year TIPS—also supported the bearish price action. Treasury yields fell marginally on Friday after a surprisingly benign January inflation report, which included a month-over-month -0.1% core CPI print.

Europe

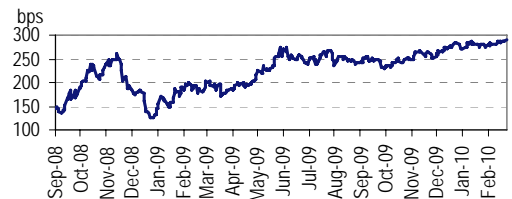
The short end of the European curve rallied strongly this week, with two-year notes falling five basis points, and the two-to-ten year curve flattening three basis points. The market has now effectively priced out any rate hike by the European Central Bank in 2010, and expecting slower growth in Europe as the peripheral countries (such as Greece, Spain, Portugal) are forced to tighten fiscal policy—dampening economic activity. Spreads of these countries over Bunds has stabilized, and we expect it will continue to trade in a range. The market will be putting pressure on countries to demonstrate detailed plans to address their fiscal situations, while on the other hand there is increasing certainty that the EU will not allow a member default.

Japan

Sentiment in Japan also improved on the back of stronger US economic data, boosting domestic stock markets and causing government bond yields to rise slightly. The equity performance was on par with that seen in the US, signaling the importance of "risk appetite" in the market. Meanwhile, Japan's fourth-quarter GDP grew faster-than-expected, led by exports, boosting domestic sentiment further. Finally, S&P stated that it was unlikely to downgrade Japan this year as a result of its fiscal position—though, as we have said, this remains a concern in developed markets globally.

10-Year Treasury Yield Spread

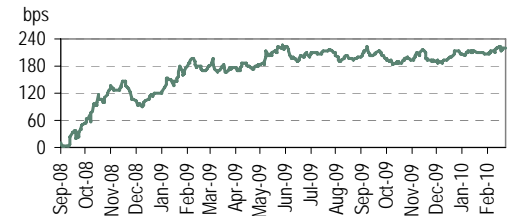
	US		Change in Level (bp)		
	Current	1wk	MTD	YTD	
Fed	0.25	0	0	0	
3 Mo	0.10	1	3	5	
2 Yr	0.92	9	10	-22	
5 Yr	2.45	12	13	-23	
10 Yr	3.78	8	19	-6	
30 Yr	4.70	5	22	6	
2 - Fed	0.67	9	10	-22	
5 - 2	1.53	3	2	-1	
10 - 5	1.32	-4	6	17	
30 - 10	0.93	-3	3	13	



Source: Bloomberg

10-Year Bund Yield Spread

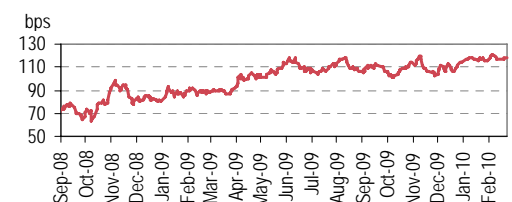
	Europe		Change in Level (bp)		
	Current	1wk	MTD	YTD	
ECB	1.00	0	0	0	
1 Yr	0.60	9	-1	-19	
2 Yr	1.09	10	-3	-25	
5 Yr	2.29	7	1	-13	
10 Yr	3.29	9	9	-10	
30 Yr	4.01	9	9	-10	
2 - ECB	0.09	10	-3	-25	
5 - 2	1.20	-3	5	11	
10 - 5	1.00	2	7	3	
30 - 10	0.73	0	0	0	



Source: Bloomberg

10-Year JGB Yield Spread

	Japan		Change in Level (bp)		
	Current	1wk	MTD	YTD	
BOJ	0.10	0	0	0	
1 Yr	0.12	0	0	-1	
2 Yr	0.16	-1	0	1	
5 Yr	0.51	-1	1	4	
10 Yr	1.34	0	1	4	
20 Yr	2.17	2	5	6	
30 Yr	2.33	2	5	6	
2 - BOJ	0.06	-1	0	1	
5 - 2	0.35	-1	2	3	
10 - 5	0.82	1	0	0	
30 - 10	0.99	2	3	2	



Source: Bloomberg

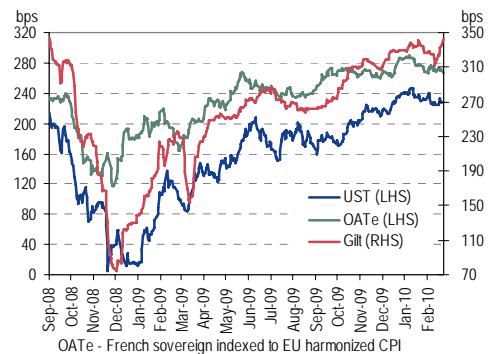
Market Review: Global Inflation-Linked Bonds (GILBs)

Although concerns about Greece's fiscal problems continued to linger, the market focused on better economic data this week. The improvement in risk sentiment, as evidenced by stronger equity and commodity markets, helped US and UK breakeven inflation (BEI) on the week.

In the US, core inflation came in at -0.1% in January on a month-over-month basis, as shelter costs showed a sizable drop. This lower-than-expected inflation report and supply pressure caused BEI to give up some gains on Friday; on the week, however, BEI widened by four-to-eight basis points in the three-to-20 year sector.

In the UK, a dovish Quarterly Inflation Report showed downward adjustments in both growth and inflation projections when compared to the November report. The following developments also weighed on UK BEI: lower inflation forecasts, an expectation that the Bank of England (BoE) would be on hold for longer and supply pressure (UKTI 2047 mini-tender). However, BEI rebounded 10 to 15 basis points in the 10-to-50 year sector over the week, helped by better risk appetite and the sell-off in conventional Gilts. UK CPI for January came in at 3.5% (y.o.y.), far in excess of the 2% BoE target. This triggered a letter from BoE Governor King to the Chancellor in which Governor King highlighted the transitory nature of the spike in inflation, emphasizing that spare capacity in the economy will likely bring CPI back to its target in the medium term.

GILBs - 10-Year Breakeven Spreads



Source: Bloomberg

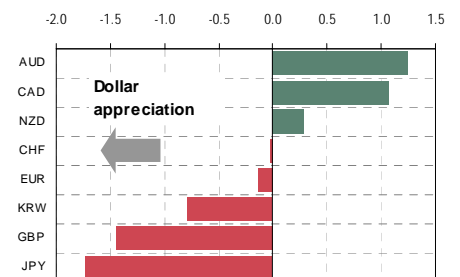
Market Review: Currency Markets

G10

The US dollar continued its outperformance against the euro and Japanese yen this week while underperforming against a handful of commodity currencies. The recovery in risk appetite coupled with the outperformance in commodity prices provided a near-term base for the Australian and Canadian dollars. The market remained worried about Greece's fiscal health, sending the euro to a new cyclical low. Meanwhile, the unexpected discount-window rate-hike by the Federal Reserve extended losses in Treasuries and gains in the US dollar as interest rate differentials moved in favor of the US.

Emerging market currencies were largely unchanged or slightly stronger against the US dollar.

US Dollar's WTD Performance Against Other Majors



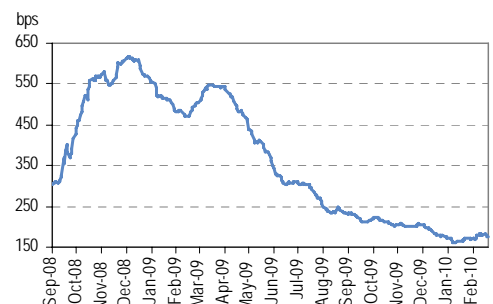
Source: Bloomberg, performance in percentage points (%)

Market Review: Credit

US Corporates

US corporate bonds, relative to Treasuries, recovered during the week following a broad recovery in riskier assets and most likely due to progress to correct Greece's financial situation. Also supporting corporates was a distinct lack of issuance, a reason for optimism concerning performance this year. The spread on the Barclays index tightened from 181 to 176 basis points, allowing the month-to-date returns versus Treasuries to recover to -35 basis points from last week's -66 basis points.

Investment-Grade Corporate Bond Index OAS



Source: Barclays Capital

Market Review: Credit (continued)

European Corporates

As has been their pattern this year, European corporate issues showed less volatility than in the US issues. In fact, the index spread remained constant at 171 basis points over the week. Month-to-date returns versus matched German Bunds were also unchanged at -22 basis points.

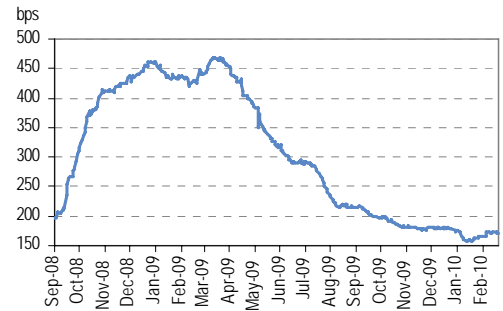
Mortgage-Backed Securities

Mortgages underperformed comparable-duration Treasuries by eight basis points last week, bringing the month-to-date excess return to essentially zero. Despite this seemingly benign environment, the landscape of the MBS market has changed considerably over the last few weeks. The GSEs announced accelerating its buyouts of seriously delinquent loans from securitizations, impacting prepayment-sensitive securities and higher coupon pass-throughs. In particular, securities backed by loans with the worst credit profiles repriced to reflect onerous prepayment assumptions.

Asset-Backed Securities

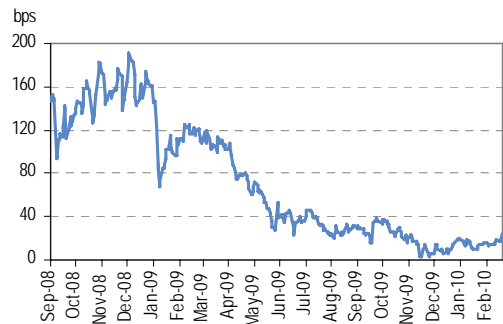
Issuance totaled US\$2.3 billion last week in two prime auto deals, and both priced tighter than initially expected among strong demand. The one-year tranche of the Honda (HAROT) deal was priced at E+12, representing a new tight level in the market. This showed the positive tone in the market as scarcity kept spreads stable. Spreads across European ABS sectors were mostly stable with some slight tightening in credit cards. ABX markets were up around one point on the week on AAA-rated issues, while subordinate issues remained stable.

Euro-Aggregate Corporate Index OAS



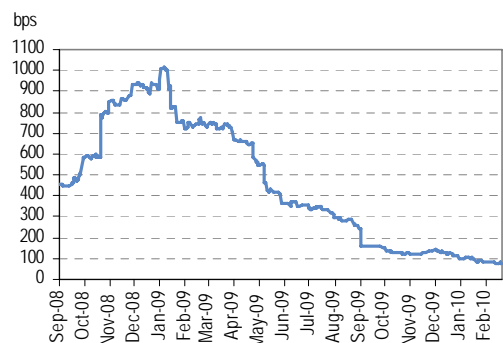
Source: Barclays Capital

MBS Current-Coupon Fixed-Rate OAS



Source: Barclays Capital

Barclays Capital ABS Index OAS



Source: Barclays Capital



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