

WEEKLY COMMENTARY: The Beginning of the End of the Correction?

Major Developments:

Monday, January 25:

- Bank of Japan (BoJ) met and held target rate at 0.1%
- US Existing Home Sales falls -16.7%, m.o.m.

Tuesday, January 26:

- UK GDP rises 0.1%, q.o.q.
- US Consumer Confidence Index rises from 52.9 to 55.9
- US House Price Index rises 0.7%, m.o.m.

Wednesday, January 27:

- US FOMC Rate Decision left unchanged at 0.25%
- US New Home Sales falls -7.6%, m.o.m.

Thursday, January 28:

- US Initial Jobless Claims falls from 482K to 470K
- Japan National CPI rises from -1.9% to -1.7%, y.o.y.
- Japan Jobless Rate falls from 5.2% to 5.1%

Friday, January 29:

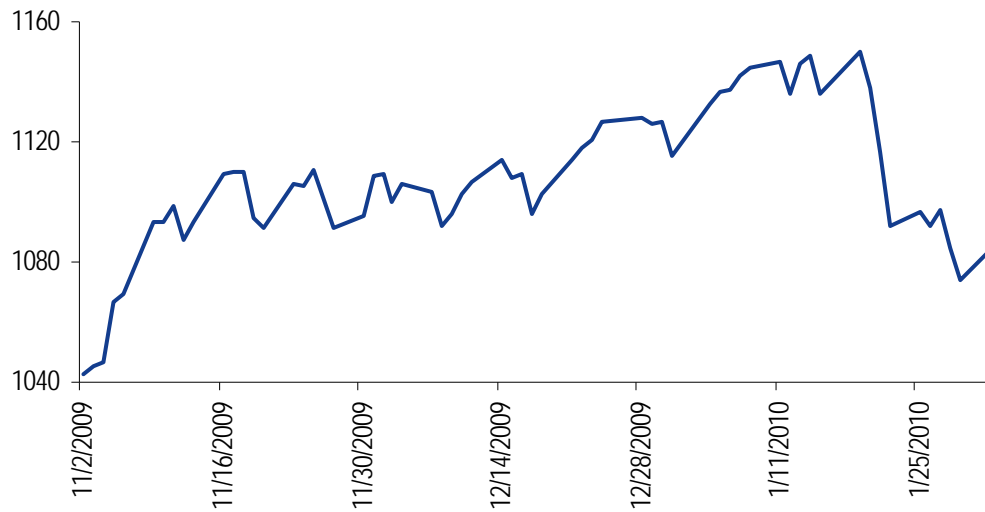
- US GDP rises 5.7%, q.o.q.
- US University of Michigan Confidence Index rises from 72.8 to 74.4

January has been a difficult month for "risky" asset classes, for developed country equities, emerging market equities, currencies, and other bellweathers of global "risk appetite". Last week continued the month's trend, with markets nervously focused on a range of factors. Greece remains a concern to the market insofar as its debt burden and credit-rating uncertainty is potentially a much wider problem across the developed markets. A Greek government bond issue last week started well, leading to spread tightening, until the government then announced another bond issue, raising concerns about supply again. Additionally, there is ongoing brinkmanship between Greece and the European Union about whether the country would receive financial assistance, and what the terms would be. To the extent that this increases uncertainty, markets remain more volatile. In the end, it is our view that Greece will receive assistance, and volatility will subside, but in the meantime, it remains another factor depressing market sentiment.

Back in the United States, economic data for the past few weeks has generally surprised on the downside, dampening enthusiasm that the US economy was recovering quickly, and raising the specter of a "double-dip". We do not subscribe to the view that the US economy will suffer another downturn, but we recognize that many in the market do fear such an outcome, and thus, when economic data goes through a softer patch, those fears will bubble to the surface, hurting the performance of riskier asset classes and strengthening the US Treasury market. Furthermore, the results of the FOMC meeting last week gave markets yet another reason to worry: Thomas Hoenig dissented from the other members on whether the FOMC should continue to use the "extended period" language referring to how long the Federal Reserve would keep interest rates low. So, amidst a period of relatively weak economic data, there was one sign from the FOMC that support for low rates was waning. Of course, Hoenig is a well-known "hawk" and his dissent is consistent with his recent comments, and ultimately, there are no signs yet that the other members are growing impatient with low interest rates.

Finally, last Friday US fourth-quarter GDP was released, beating expectations at +5.7% annualized. While this could have been more supportive for the markets (Treasury bonds rallied after briefly selling off), the data was positive, raising hopes that the current period of weaker-than-expected economic data could be coming to an end. Looking ahead to next week, Monday's ISM data (as of this writing) was better-than-expected, lifting markets. With ADP employment data to come, and the week culminating with the US Non-Farm Payrolls data, there could be a better tone to markets going into February. There certainly has been a significant correction in many riskier markets, particularly equities, in the past few weeks. Thus, from a valuation perspective, it may only take a little better economic news to boost markets. Looking ahead to February, we are optimistic that sentiment will improve: looking back, we may see this week as the beginning of the end of the correction.

Chart of the Week: S&P 500 Index



Source: Bloomberg

Next Week:

Tuesday, February 2:

- US Pending Home Sales expected to rise 1.0%, m.o.m.
- UK Nationwide Consumer Confidence Index expected to rise from 69 to 70

Wednesday, February 3:

- US ADP Employment Change expected to rise from -84K to -40K

Thursday, February 4:

- Bank of England (BoE) expected to leave interest rates unchanged at 0.50%
- European Central Bank (ECB) expected to leave interest rates unchanged at 1.00%
- US Initial Jobless Claims expected to fall from 470K to 455K

Friday, February 5:

- US Unemployment Rate expected to remain at 10.0%
- US Change in Nonfarm Payrolls expected to rise from -85K to 8K

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%	0.29%	March 16
ECB	-25 bps	May 7, 2009	1.00%	0.70%	February 4
BoJ	-20 bps	December 18, 2008	0.10%	0.42%	February 18
BoE	-50 bps	March 5, 2009	0.50%	0.64%	February 4

Market Review: Sovereign Bond Markets

United States

While Treasury yields closed the week almost unchanged, intraday price action was quite volatile as the bond market reacted to sharp moves in sovereign spreads, equities, and currencies. A significant sell-off in Greek debt triggered a broad sell-off in global equities and strong demand for core eurozone government debt, and US Treasuries rallied in sympathy. Meanwhile, the FOMC statement maintained "the extended period" language, although Hoenig's dissent and an upgraded growth forecast helped lead to a bear-flattening sell-off. New Treasury issuance was met with decent demand with all three auctions ending fairly close to the 1pm level. On the data front, existing home sales and new home sales were weaker than expected while fourth quarter GDP and Chicago PMI surprised to the upside.

Europe

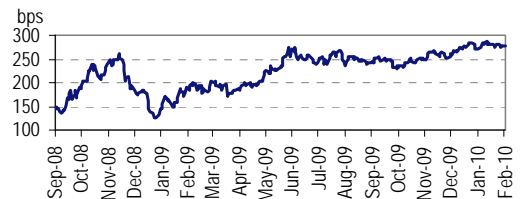
Sovereign risk concern in the eurozone intensified this week as peripheral spreads widened significantly. In particular, spreads between 10-year Greek bonds over their German counterparts widened 60 basis points to 395 basis points, well past the peaks seen in 2009. On the data front, French consumer spending rose more than expected and German IFO also came in better-than-expected. In the UK, Gilt yields saw little change over the week although intraday price actions remained volatile. On the data front, fourth-quarter GDP disappointed with a modest 0.1% growth versus expected 0.4%, while the Nationwide House Price Index rose for the ninth consecutive month.

Japan

Japanese government yields rallied about one to three basis points in response to a weakness in global equities and heightened sovereign risk. S&P lowered Japan's AA rating for sovereign debt to negative, noting the Japanese government's diminishing economic policy flexibility may lead to a downgrade unless measures can be taken to stem fiscal and deflationary pressures. The market reaction to the S&P announcement was limited. On the policy front, the BoJ maintained its target rate at 0.10% and left policy measures unchanged.

10-Year Treasury Yield Spread

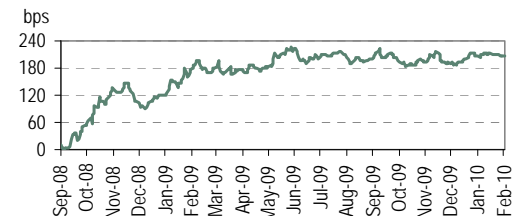
	US			
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.07	3	2	2
2 Yr	0.82	2	-32	-32
5 Yr	2.33	-2	-36	-36
10 Yr	3.59	-2	-25	-25
30 Yr	4.49	-4	-15	-15
2 - Fed	0.57	2	-32	-32
5 - 2	1.51	-4	-3	-3
10 - 5	1.26	-1	10	10
30 - 10	0.90	-2	10	10



Source: Bloomberg

10-Year Bund Yield Spread

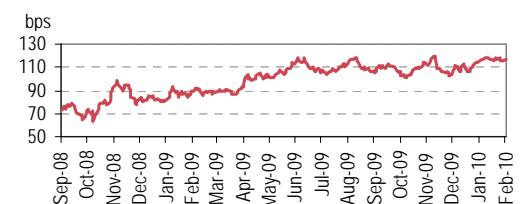
	Europe			
	Current	1wk	MTD	YTD
ECB	1.00	0	0	0
1 Yr	0.61	1	-19	-19
2 Yr	1.12	1	-21	-21
5 Yr	2.28	-2	-15	-15
10 Yr	3.20	-2	-19	-19
30 Yr	3.93	-8	-19	-19
2 - ECB	0.12	1	-21	-21
5 - 2	1.16	-2	7	7
10 - 5	0.92	0	-4	-4
30 - 10	0.73	-6	0	0



Source: Bloomberg

10-Year JGB Yield Spread

	Japan			
	Current	1wk	MTD	YTD
BOJ	0.10	0	0	0
1 Yr	0.12	-1	-1	-1
2 Yr	0.16	0	1	1
5 Yr	0.50	-2	3	3
10 Yr	1.32	-1	3	3
20 Yr	2.12	-1	1	1
30 Yr	2.28	-1	2	2
2 - BOJ	0.06	0	1	1
5 - 2	0.34	-2	1	1
10 - 5	0.82	1	0	0
30 - 10	0.96	0	-1	-1

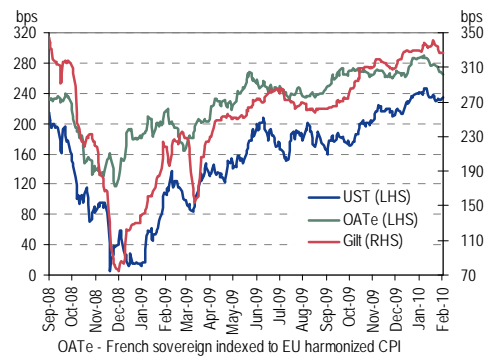


Source: Bloomberg

Market Review: US Inflation-Linked Bonds (TIPS)

Despite the strength in nominal Treasuries, TIPS held their own, with 10-year breakevens trading in a steady 230 to 236 basis points range during the week, and real yields trading between 1.24% and 1.34%. Nevertheless, within the TIPS curve, longer-dated issues significantly outperformed while near-dated TIPS lost some appeal amid a pullback in commodities as investors sought to lengthen portfolio duration for the 2.4-month index extension. Jan 2025 TIPS were the best-performing issue on the curve, initially offering the same breakeven inflation rate as the on-the-run 2020s. February brings a new 30-year TIPS auction, which will keep the focus on the back-end, but with 10-year 10-year inflation forwards still below five-year five-year forward rates, we anticipate the sector to do well once the supply is out of the way.

GILBs - 10-Year Breakeven Spreads



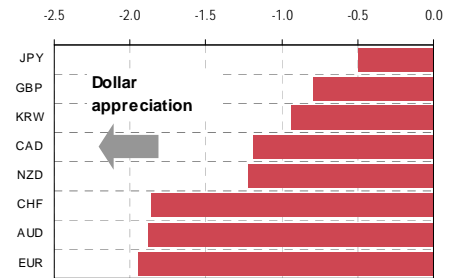
Source: Bloomberg

Market Review: Currency Markets

G10

The US dollar was firmer across the board against the majors this week. Ongoing concerns about the impact of Chinese tightening and the Greek situation continued to weigh on risk appetite. Global equity markets remained under pressure which led to further unwinding of long Asian currencies. Hoenig's dissenting vote in the FOMC minutes added more unease to the market, which in turn led to more uncertainty on the timing of the Fed's tightening. Unsurprisingly, EMFX also traded poorly on further risk aversion.

US Dollar's WTD Performance Against Other Majors



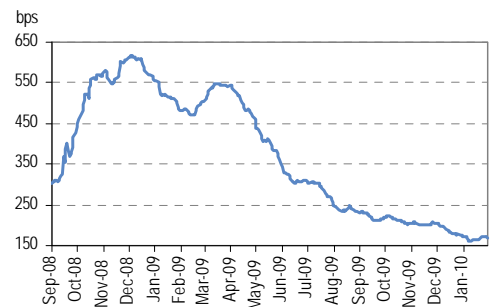
Source: Bloomberg, performance in percentage points (%)

Market Review: Credit

US Corporates

Corporate bond returns lost ground to Treasuries this week. Spreads widened by about five basis points, with much of the weakness in long maturities; the on-the-run synthetic index also widened by five basis points. The market felt the brunt of a number of factors: renewed concern over regulatory and tax policies on banks, weaker equity markets (despite generally good earnings reports), and broader concerns over risk aversion stemming from Greece.

Investment-Grade Corporate Bond Index OAS



Source: Barclays Capital

Market Review: Credit (continued)

European Corporates

European corporate bonds fared better than US corporates, though they still underperformed Bunds. Spreads widened by three basis points, driving excess returns for the month to +58 basis points from +71 basis points.

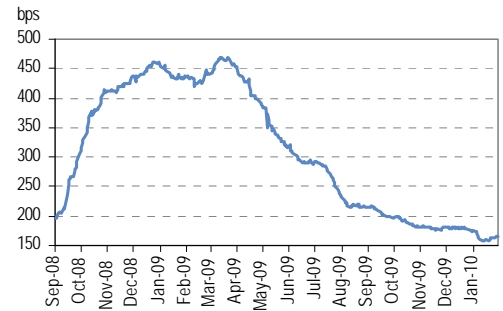
Mortgage-Backed Securities

Mortgages outperformed comparable-duration Treasuries by three basis points last week as 12 basis points of coupon return was offset by marginally wider spreads. There are two months and US\$90 billion of MBS left to the Fed mortgage-purchase program and the market is pondering how it will trade afterwards. For the time being, more bonds are being bought than are originated, keeping technical conditions firm. The Treasury continued to march forward with the HAMP program last week by giving servicers more leeway in converting trial modifications into permanent ones, as documentation has been the biggest hurdle for the program.

Asset-Backed Securities

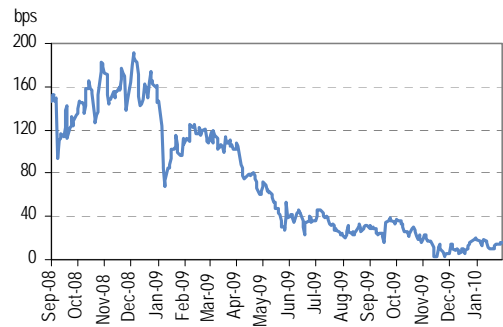
Issuance totaled US\$4.4 billion last week across the auto, credit card and UK Prime RMBS sectors last week. All deals were oversubscribed and priced tighter than initial talk levels. This reflects the positive tone in the market, as scarcity keeps spreads stable amid the stock market retreat. On the European side, the PERMA deal from HBOS met strong demand as the three-year US dollar tranche priced at three-month LIBOR plus 115 basis points. Spreads across European ABS sectors tightened slightly as investor interest increased. ABX markets were up about one point at the AAA level on the week.

Euro-Aggregate Corporate Index OAS



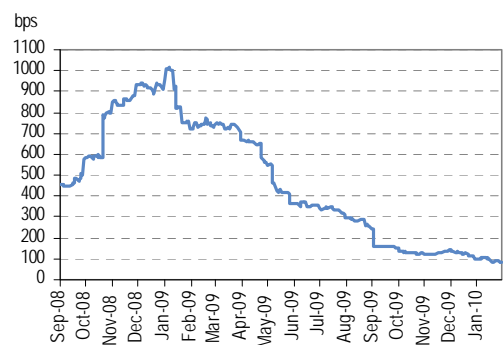
Source: Barclays Capital

MBS Current-Coupon Fixed-Rate OAS



Source: Barclays Capital

Barclays Capital ABS Index OAS



Source: Barclays Capital



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