

JANUARY 13, 2012
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WEEKLY COMMENTARY:

The Outlook for 2012: Cloudy with a Chance of Storms

Major Developments:

Monday, January 9:

- Germany Industrial Production growth decreased -0.6% m.o.m. for November.

Tuesday, January 10:

- France Industrial and Manufacturing Production growth increased 1.1% and 1.3% m.o.m., respectively, for November.
- Bank of France Business Sentiment Indicator increased to 96 for December.

Wednesday, January 11:

- Germany GDP growth decreased to 3.0% y.o.y. in November.

Thursday, January 12:

- France CPI remained at 2.5% y.o.y. for December.
- Germany CPI remained at 2.1% y.o.y. for December.
- UK Industrial and Manufacturing Production growth fell -0.6% and -0.2% m.o.m., respectively, for November.
- US Initial Jobless Claims increased to 399,000 for the week.

Friday, January 13:

- US Import Price Index declined 0.1% for December.
- US University of Michigan Consumer Confidence Survey increased to 74.0 for January.

FFTW held its annual investment offsite meeting in New York this week, giving a chance for us to come together and discuss both what worked in 2011 and what we believe are the opportunities most likely to seize in 2012 for our clients.

- The good and bad news on yields in developed markets is that we believe that none of the “big four”—the Federal Reserve, the Bank of England, the European Central Bank and the Bank of Japan—will be raising policy rates in 2012. It is more likely than not that we will see further quantitative easing (QE) in the United States, in addition to its new policy of signaling to markets what its own reaction function is. Some aggressive forecasters see no move in UK rates until 2016. While Japan's growth has been surprisingly better than expectations, we do not expect to see its rates rising, either. In continental Europe, rates are likely to fall to 0.50%, with observers divided on whether ECB President Mario Draghi has ruled out QE absolutely or merely the “EQE” variety, whereby peripheral debt could be monetized. With the 10-year yield below 2% in each of these markets, room for significant capital appreciation is limited, and risks are skewed the other way. It also follows, however, that we foresee few pressures to cause yields to back up meaningfully.
- Our interest rate forecasts take place against a backdrop of positive US growth, although it remains both our belief—and perhaps, more importantly, that of the Federal Reserve—that growth will remain well below trend. With corporations still sitting on record levels of cash, the sector is one that, we believe, has some upside. Higher-coupon MBS face high prepayment risk, but housing appears to be stabilizing, and spreads are attractive—particularly in a lower volatility environment. All of this must be contrasted with the European outlook, which is currently unfavorable. Investors face the same yield pressures versus Bunds, but wide peripheral government spreads mean that, for much of the continent, monetary policy is not accommodative at all. This is heightened by demands for pro-cyclical austerity. Banks are under pressure to recapitalize, and it follows that lending appetite is low. A theme for 2011—the ongoing effective subordination of senior bank debt by covered bond issuance—continues to put pressure on financials, the dominant credit sector in European indices. Lastly, these factors have combined with depressed confidence to put in place all the ingredients for a pronounced recession. Name-specific opportunities will arise, but on a secular basis European credit does not offer an easy way to pick up yield.
- The European sovereign debt crisis will probably not see a definitive end in 2012, and continued funding pressures on countries outside a handful in the core will manifest into demands for greater austerity. This risks choking the growth that many believe to be the only effective way out. As we saw on January 13 with the S&P downgrades, one risk to investors may not be default *per se*, but the risk of a downgrade below a permitted holding threshold. Portugal is now no longer investment grade, and Italy has moved to BBB+. While in some cases investors' strong stomachs may be rewarded, it will be a rocky ride without a guaranteed happy ending. A smaller euro area is a real possibility, and with it the Pandora's Box of contagion. The impediments to a solution remain political, but that is not to deny that impediments exist.
- In foreign exchange markets, the main view in the first quarter of 2012 is that a euro facing sharp rate cuts and a chance of QE in response to a recession is overvalued, and we expect to be underweight the euro. The second broad theme, though, is that “currency wars,” to use Brazilian Finance Minister Guido Mantega's term for competitive devaluations, may be over. The high watermark may have been the Swiss National Bank's decision to cap the appreciation of the Swiss franc versus the euro in September. Currencies more likely to respond to changes in the macroeconomic and monetary outlook likely will lend themselves to a quantitative rules-based approach as much as a judgmental one, and FFTW will be looking to re-implement these strategies.

Outlook for 2012 (cont.):

- When looking at China, we would not substitute our forecasting expertise for that of experts embedded in that economy. Nonetheless, we believe it more likely than not that China will experience a “soft landing.” Recent industrial production and business confidence data is leaning in this direction, and on the other side we take at face value the government’s desire to allow the overheated property market to deflate. Bank balance sheets in state-controlled entities make a true picture hard to grapple with, but we believe China is more likely than not to continue to be able to support aggregate global demand. What is true of China specifically is also true of emerging markets (EM) more generally, where selective spread opportunities are attractive.

The conclusion we reach is that rates will likely remain low. The risks are skewed to the upside, but we can identify few catalysts for this to happen. As the world deals with another year of below-trend growth, asset classes where we can take advantage of higher coupons are likely to be attractive, particularly in the US—but the risks are unlikely to compensate us similarly in Europe. Foreign exchange markets present clearer opportunities when central bank intervention is less of a risk. So far, we are in the “soft landing” camp, and this augurs well for risk-taking in other emerging markets.

We look forward to discussing these themes with all our clients as the year progresses.

Next Week:

Monday, January 16:

- Japan Consumer Confidence Survey is expected to increase to 38.5 for December.

Tuesday, January 17:

- UK CPI is expected to decrease to 4.2% y.o.y. for December.
- US Empire State Manufacturing Survey is expected to increase to 11.0 for January.
- Euro area CPI is expected to decrease to 2.8% y.o.y. for December.

Wednesday, January 18:

- UK ILO Unemployment Rate is expected to remain at 8.3% for November.
- US PPI is expected to decrease to 5.1% y.o.y. for December.
- UK Nationwide Consumer Confidence Survey is expected to decrease to 38 for December.

Thursday, January 19:

- US Housing Starts are expected to decrease 0.7% m.o.m. for December.
- US CPI is expected to decrease to 3.0% y.o.y. for December.

Friday, January 20:

- Germany PPI is expected to decrease to 4.6% y.o.y. for December.
- UK Retail Sales are expected to increase to 0.6% m.o.m. for December.

Source: Bloomberg

Central Bank Watch:

	Last Move	Date of Move	Current Policy Rate	Implied 3-Month Rate on Mar 2012 Interest Rate Futures Contract	Next Meeting
Fed	-75 bps	December 16, 2008	0% - 0.25%	0.09%	January 25
ECB	-25 bps	December 8, 2011	1.00%	0.34%	February 9
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.33%	January 24
BoE	-50 bps	March 5, 2009	0.50%	1.02%	February 9

Market Review: Sovereign Bond Markets

United States

A strong auction of 10-year Treasury notes, successful auctions of short-dated Spanish & Italian debt, weaker-than-expected retail sales for the month of December, and S&P's downgrade of France on Friday, January 13, were the main drivers of US Treasury markets this week. The week began with a rally in US Treasury yields following a strong auction of 10-year notes. Successful auctions of short-dated Spanish and Italian debt on Wednesday saw a sell-off in Treasuries. However, S&P's downgrade of France's AAA rating on Friday resulted in a bounce-back, pushing yields lower for the week.

Europe & Japan

Spain successfully sold €10 billion of new bonds (twice the maximum sale target set), maturing in 2015 and 2016 and at yields of 3.38% compared to 5.19% on similar securities sold in December. Italy sold €8.5 billion of one-year bills at 2.74% (equivalent to around half the rate of similar bonds it sold in mid-December) on January 12 and another €4.75 billion on January 13 on lower yields, as investor sentiment towards the euro area shows signs of improvement. At the end of trading on Friday, S&P downgraded France and Austria by one notch to AA+, while Italy, Portugal, and Spain were lowered by two notches. Ireland retained its investment-grade rating of BBB+. The Netherlands, Finland and Luxembourg retained their AAA ratings. As expected, S&P downgraded the European Financial Stability Fund to AA+ on Monday, January 16.

In Germany, which had its AAA rating reaffirmed with a "stable" outlook, industrial production fell 0.6% m.o.m. in November but grew 3.6% y.o.y. The country's GDP growth rate dipped lower as predicted to 3.0% y.o.y. in November. December CPI was 2.1% y.o.y. The yield on the 10-year Bund dropped nine basis points over the week to a record low 1.77%.

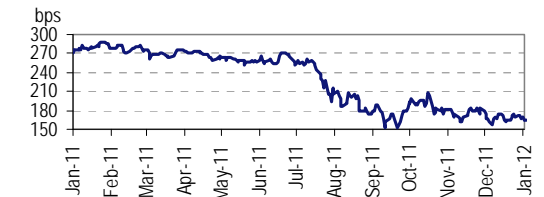
In France, manufacturing production increased 1.3% m.o.m. in November, beating estimates of 0.4%. Industrial production grew 1.1% m.o.m. in November versus an expected fall of 0.2%. The business sentiment indicator rose to 96 in December from 95 in November. France's CPI remained at 2.5% y.o.y. The yield on the 10-year French government bond declined 29 basis points over the week to 3.08%.

November industrial production in the UK fell 0.6% m.o.m. as warm weather hit energy demand, while manufacturing production fell 0.2%, as expected. The yield on the 10-year UK Gilt declined five basis points over the week to reach a new record low of 1.97%.

In Japan, November machine orders increased 14.8% m.o.m., beating the expected increase of 5.1%. The December domestic corporate goods price index rose 1.3% year-on-year. The 10-year Japanese government bond yield fell three basis points over the week to 0.95%.

2- to 10-Year Treasury Yield Spread

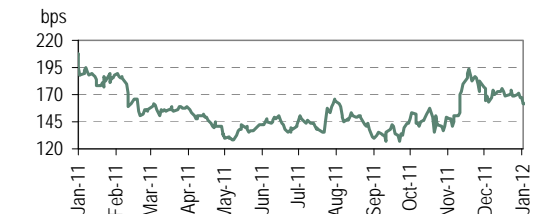
US	Change in Level (bp)			
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.02	1	1	1
2 Yr	0.22	-4	-2	-2
5 Yr	0.79	-6	-4	-4
10 Yr	1.86	-10	-1	-1
30 Yr	2.91	-11	2	2
2 - Fed	-0.03	-4	-2	-2
5 - 2	0.57	-3	-2	-2
10 - 5	1.07	-3	3	3
30 - 10	1.05	-1	3	3



Source: Bloomberg

2- to 10-Year Bund Yield Spread

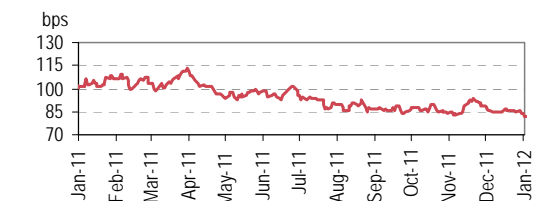
Europe	Change in Level (bp)			
	Current	1wk	MTD	YTD
ECB	1.00	0	0	0
1 Yr	0.08	14	14	14
2 Yr	0.15	-1	1	1
5 Yr	0.75	-3	-1	-1
10 Yr	1.77	-9	-6	-6
30 Yr	2.35	-9	-2	-2
2 - ECB	-0.85	-1	1	1
5 - 2	0.60	-2	-2	-2
10 - 5	1.01	-6	-6	-6
30 - 10	0.59	0	5	5



Source: Bloomberg

2- to 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	0
2 Yr	0.13	0	0	0
5 Yr	0.34	0	-1	-1
10 Yr	0.95	-3	-4	-4
20 Yr	1.74	-2	-1	-1
30 Yr	1.94	0	1	1
2 - BOJ	0.03	0	0	0
5 - 2	0.20	0	-1	-1
10 - 5	0.62	-3	-3	-3
30 - 10	0.98	3	5	5



Source: Bloomberg

Market Review: Emerging Markets

Investor perceptions about recession risks have been further eased by the flow of data from the United States and China. EM currencies have appreciated over the week, with the high betas outperforming (Brazilian real, Indian rupee, Turkish lira). In EM credit, Venezuela has been underperforming on news that it will be issuing new debt earlier than expected. China's December CPI came in higher than expected at 4.1%. China's December M2 money supply growth rebounded, contributing to the better-than-expected December PMI and possibly leading to a stronger-than-expected fourth quarter GDP. Bank Indonesia kept its policy rate unchanged at 6.0%, as expected. Poland also kept its policy rate unchanged this week at 4.5%, as expected. Hungarian assets (foreign exchange, credit and local yield) have rallied as the market is pricing in an increased likelihood that a deal with the IMF and EU can ultimately be secured.

JP Morgan Global Emerging Markets Bond Index



Source: Bloomberg

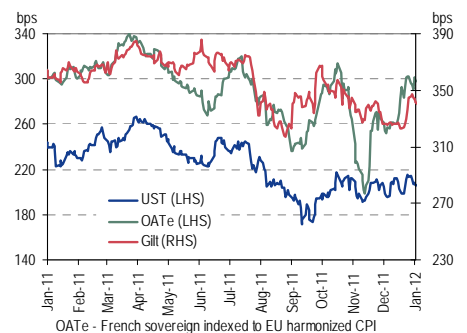
Market Review: Global Inflation-Linked Bonds

Despite a stronger tone in the US equity market, nominal Treasuries rallied over the week while TIPS failed to keep up with the strong performance; US breakeven inflation (BEI) narrowed seven basis points in the 10-year sector. Perhaps also adding pressure to US BEI is the impending, larger-than-usual US\$15 billion in new 10-year TIPS supply. The issuance occurs in an unusual January when no TIPS mature (there is usually a TIPS issue that matures in January). This may have a marginal impact on demand due to relatively fewer reinvestment flows and the associated shorter-than-usual month-end index duration extension.

In Europe, investors were wary of holding Italian inflation-linked bonds (ILBs), as they are vulnerable to index selling if Italy's composite rating falls below single A. Italian BEI rates performed poorly in anticipation of a sovereign credit downgrade by S&P, with 10-year BEI spreads narrowing from 1.25% to 0.63% over the week. Although Italy remains in the widely followed ILB indices after Friday's S&P two-notch downgrade to BBB+, it will fall out of those indices if we see similar action from either Moody's or Fitch.

In the UK, the £700 million UKTI 2047 reopening went smoothly, and the Debt Management Office also announced that UKTI 2062 will be reopened via syndication during the second half of February, with a potential size of around £3.5 billion. Despite sizable impending supply, UK real yields continued to march lower over the week, with UKTI 2062 closing the week at -0.16%.

GILBs - 10-Year Breakeven Spreads



Source: Bloomberg, performance in percentage points (%)

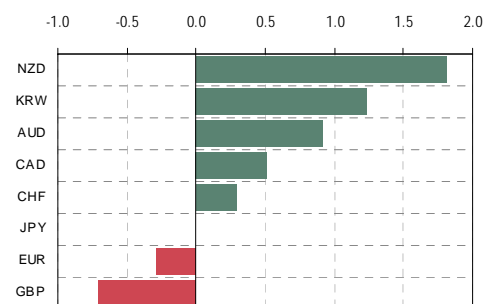
Market Review: Currency Markets

G10

The euro and other European currencies were the worst performers on the week, falling about 1% across the board. Cyclical currencies outperformed, with the New Zealand, Australian and Canadian dollars rallying. Stabilization in risk appetite and increased focus on cyclical drivers has seen growing divergence between the European currencies and other G10 currencies as well as EM currencies. The latter group has been supported by more upbeat US news and the perceived reduction in tail risks in the European debt crisis and of a hard landing in China.

Although the risk of a Greek restructuring is still looming in the background and S&P downgraded several European countries' ratings, inflows to EM and equity funds were quite strong. Latin American and Asian EM currencies all outperformed this week as risk appetite improved.

US Dollar's WTD Performance Against Other Majors

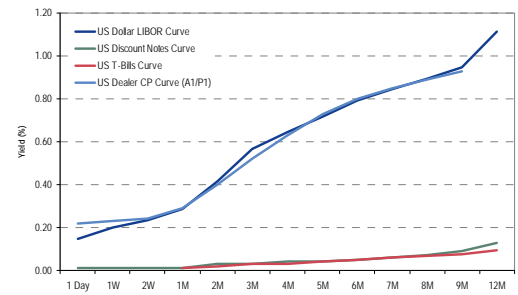


Source: Bloomberg, performance in percentage points (%)

Market Review: Money Markets

Money markets retained their firm New Year's tone as investors again bought duration in order to redeploy year-end liquidity positions and possibly to lock in rates ahead of a potential rally. Daily commercial paper volume tapered only slightly from last week's exuberant US\$106 billion rate, but volume in the longest maturity bucket actually increased, capturing nearly 11% of the total. Enthusiasm for preferred Canadian and Nordic CDs allowed issuers to tighten levels in a notable reversal from recent market trends. Japanese names also saw good volumes as investors minimized their euro area holdings. Short Australian and Canadian floating rate notes (FRNs) sold well based on quality despite shrinking discount margins. LIBOR benchmarks edged about one basis point lower this week after six months of steady firming. S&P's European downgrades occurred too late on Friday for their effect to be visible until the following week.

Money Market Yield Curves



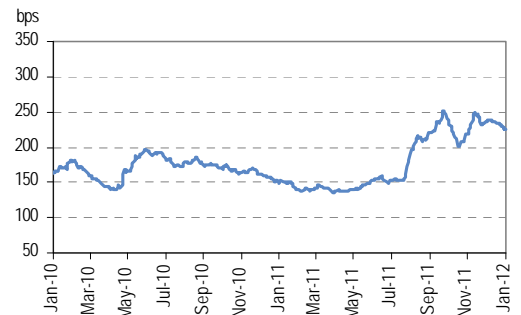
Source: Bloomberg

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

US and European corporate bonds outperformed government bonds for the fourth consecutive week. Successful government bond auctions in Italy and Spain improved investor sentiment. Markets closed with some uncertainty Friday as investors anticipated S&P downgrades of European sovereigns. The downgrades finally came much as expected after the US close Friday afternoon. US economic data was mixed for the week (weaker retail sales, initial claims and trade balance data but better-than-expected consumer confidence). US fund flows picked up this week. High-grade bonds had US\$1.8 billion in inflows, up from US\$1.1 billion last week. High-yield bonds had US\$1.8 billion of inflows versus US\$774 million last week.

Investment-Grade Corporate Bond Index OAS

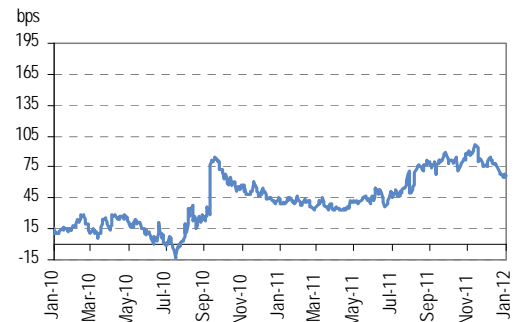


Source: Barclays Capital

Mortgage-Backed Securities

The mortgage sector continues to do well in the beginning of 2012, outperforming duration-matched Treasuries by 10 basis points. The Federal Reserve demand continues to outpace supply, supporting mortgage-backed security (MBS) tightening. The prepayment report for January was supportive for the sector, and conventional dollar rolls were also well bid. We remain positive on structured products, including MBS, commercial MBS and non-agency residential MBS.

Agency MBS Current-Coupon Fixed-Rate OAS

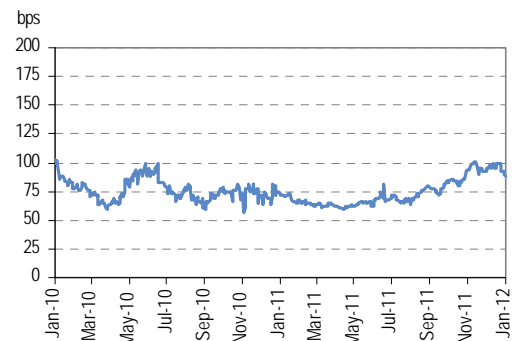


Source: Barclays Capital

Asset-Backed Securities

Asset-backed security (ABS) spreads were tighter across all asset classes by 5-to-10 basis points as the market saw good demand from investors. New issues totaled approximately US\$6.5 billion, and all priced very well with some issue upsizing due to demand. The Citi OMNI card shelf priced tighter despite the negative headlines of CIT Group pulling Sears inventory financing lines.

Barclays Capital ABS Index OAS



Source: Barclays Capital

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