

JANUARY 27, 2012
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WEEKLY COMMENTARY: Lower for Longer – Much Longer

Major Developments:

Monday, January 23:

- France Business Confidence Indicator Index decreased to 91 for January.

Tuesday, January 24:

- Euro area PMI Manufacturing and Services Surveys increased to 48.7 and 50.5, respectively, for January.
- US Richmond Federal Reserve Manufacturing Index increased to 12 for January.

Wednesday, January 25:

- UK growth was 0.8% y.o.y. through December 2011.
- US Pending Home Sales decreased 3.5% m.o.m. for December.

Thursday, January 26:

- Germany GFK Consumer Confidence Survey increased to 5.9 for February.
- US Durable Goods Order growth decreased to 3.0% m.o.m. for December.
- Japan CPI increased to -0.2% y.o.y. for December.

Friday, January 27:

- US 4th Quarter 2011 GDP growth increased to 2.8% annualized q.o.q.
- US University of Michigan Survey of Consumer Confidence increased to 75.0 in January.

The US Federal Reserve announced on December 13, 2011 that it would begin giving guidance on how long FOMC voting members expected rates to remain where they were set. The market had come to believe that the Federal Reserve would keep rates accommodative—that is, in a target range between 0%-0.25%—for the remainder of 2012 and 2013. But at this week's meeting, the FOMC surprised markets: nine of the policymakers stated that they believed rates would stay below 1% until the end of 2014, with six of those nine expecting unchanged rates over that period. In essence, the Federal Reserve wants the market to believe that rates will remain as low as they are today for at least three years. While this forecast does not bind the Federal Reserve, it is reasonable to believe that the Federal Reserve does not easily change its mind. In the press conference following this announcement, Chairman Bernanke also reiterated that the Federal Reserve would not rule out making further bond purchases. On more than one occasion, Chairman Bernanke stressed that he saw the twin objectives of stable prices and maximum employment as symmetric, and he views the 8.5% unemployment rate as still too high.

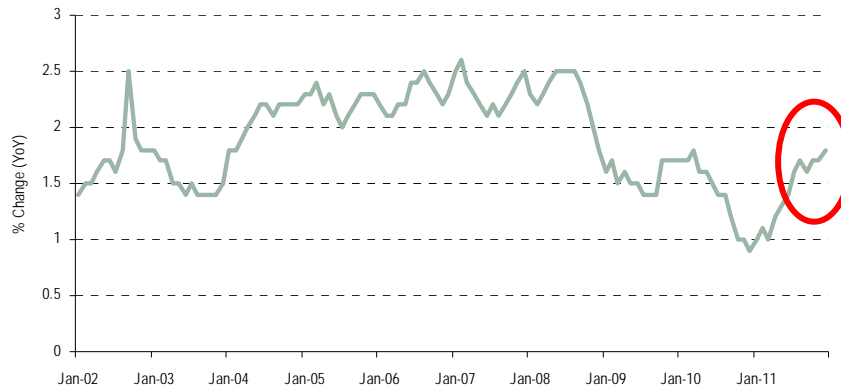
This policy should achieve two goals. The first goal is loose monetary policy almost by definition, which is to keep borrowing costs low. As well as being good in a weak economy, it helps the financial system recapitalize itself since banks can borrow funds very cheaply and gain simple profits by buying longer-dated bonds. As those yields come down, banks will tend to look for higher yields and also increase higher-margin lending. Many of us are very familiar with these operations from our economics courses. But the Federal Reserve has added the second strand of the policy, which is to clarify not just the policy rate but the time during which that policy will be effective. This introduces a new level of certainty into the equation. Axiomatically, an increase in certainty means a reduction in volatility, which is an expression of uncertainty. It follows that the other policy goal is to reduce volatility.

This is, of course, easier said than done. Indeed, one of the risks the Federal Reserve identifies is Europe—which, at the time of writing, has not been resolved. Currently, even the more positive outcomes in Europe still likely include bank balance-sheet shrinkage and recessions of varying severity. Emerging markets are also still grappling with hard- or soft-landing scenarios, and tensions continue to build regarding Iran.

But the Federal Reserve is doing what it can, and we believe that this policy has the potential to shift investor behavior in favor of riskier assets that should perform well in a lower-volatility environment. Mortgages can be viewed as a short volatility position due to their ability to extend if rates rise and pre-pay if rates fall: the best outcome is very little change. Higher-coupon mortgages are more likely to refinance away, but current coupons look attractive in this environment. High-yield credit is also an asset class that is correlated to declining volatility, and while it features in few FFTW portfolios, similar opportunities exist in investment-grade US credit, including, in particular, selective financials. Even US Treasury valuations, which look high, need to be reassessed when we consider that the risk premium embedded in longer-dated maturities should be lower with increasing certainty as to the path of fed-funds, all things being equal.

There is one additional factor, though: the risk premium in Treasuries must also consider inflation. The Federal Reserve uses the core PCE (Personal Consumption Expenditure) measure of inflation, and is targeting 2%. Indeed, a less publicized change in policy is that it has moved from a range—with 2% as its upper bound—to a simple 2%. Arguably, the Federal Reserve is marginally more dovish on inflation. The Chart of the Week (page 2) shows the US core PCE, and at 1.8%—with a steady increase from 0.9% a year ago—it is at least debatable whether investors should look to inflation protection. In conventional Treasuries, this would be through increasing the expected risk premium that the Federal Reserve's move to reduce volatility may simultaneously be decreasing. Of course, US TIPS also offer investors opportunities to hedge inflation concerns. We are certainly not forecasting an inflationary episode, but real yields are something we believe investors should be considering.

Chart of the Week: US Core PCE Index YoY 1/31/2002 – 12/31/2011



Data Source: Bloomberg

Next Week:

Monday, January 30:

- Germany CPI is expected to decrease to 2.0% y.o.y. for January.
- US Personal Income is expected to increase to 0.4% m.o.m. for December.
- US Personal Spending is expected to increase to 0.1% m.o.m. for December.

Tuesday, January 31:

- France Producer Prices are expected to decrease to 4.7% y.o.y. for December.
- US Consumer Confidence Index is expected to increase to 68.0 for January.

Wednesday, February 1:

- Euro area PMI Manufacturing Survey is expected to remain at 48.7 for January.
- US ISM Manufacturing Survey is expected to increase to 54.5 for January.

Thursday, February 2:

- Euro area PPI is expected to decrease to 4.3% y.o.y. for December.

Friday, February 3:

- Euro area Retail Sales are expected to increase to 0.3% m.o.m. for December.
- US Unemployment Rate is expected to remain at 8.5% for January.
- US ISM Non-Manufacturing Survey is expected to increase to 53.2 for January.

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%	March 13
ECB	-25 bps	December 8, 2011	1.00%	0.37%	February 9
BoJ	-20 bps	October 5, 2010	0% - 0.10%	0.33%	February 14
BoE	-50 bps	March 5, 2009	0.50%	1.01%	February 9

Market Review: Sovereign Bond Markets

United States

The Federal Reserve's announcement to keep interest rates low through at least late 2014 led to a rally in Treasuries this week. The Federal Reserve extended its previous commitment to keep rates low until at least the middle of 2013 and kept open the option of further bond purchases. This resulted in Treasuries rallying across the curve, with the five-year yield falling to a record low of 0.75% and the 10- to 30-year spread widening to approximately 116 basis points.

Europe & Japan

The euro area, led by Germany's robust performance, saw its Purchasing Managers Index (PMI) manufacturing survey rise to 48.7, beating the average expectation of 47.3. The PMI services survey printed at 50.5, exceeding expectations of 49.0. Germany's Ifo Business Climate Index beat expectations, rising to 108.3 in January from 107.3 in December. German consumer confidence data also printed better than expected at 5.9, compared to expectations of 5.6. Buoyed by the positive data, the yield on the 10-year German government bond fell seven basis points over the week to 1.86%.

In France, the January Business Confidence Indicator scored 91 against expectations of 94. The yield of the French 10-year sovereign bond fell six basis points over the week to 3.03%.

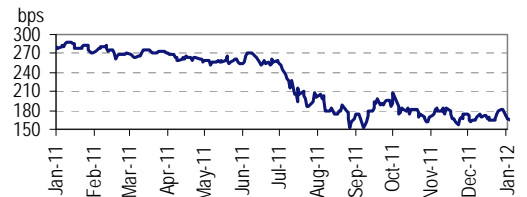
Spain's unemployment rate increased more than expected in the fourth quarter of 2011 to 22.85%. On Friday, Fitch cut Spain's credit rating two levels to A and assigned a negative outlook on the grounds of "the deterioration in the macroeconomic outlook." Despite the weak data, the yield on Spain's 10-year government bond fell 52 basis points over the week to 4.97%; Spain's Prime Minister, Mariano Rajoy, reiterated at his visit to Berlin his government's commitment to the agreed deficit targets of 4.4% of GDP in 2012 and 3% in 2013. Italy was also downgraded two notches by Fitch to A- with a negative outlook. The yield on Italy's 10-year government bond also fell lower over the week to 5.60%, a drop of 35 basis points.

The UK economy grew by 0.8% year-on-year but contracted by 0.2% quarter-on-quarter, driven by cuts in manufacturing output, stagnation in the output of services, and the public sector strikes, according to Wednesday's GDP data. The yield on the UK 10-year Gilt fell five basis points to 2.07%.

In Japan, retail sales grew at their fastest pace since August 2010. Retail sales rose 2.5% in December 2011 from a year earlier and exceeded the 2.1% median forecast. The yield on the 10-year Japanese government bond closed the week down two basis points to 0.97%.

2- to 10-Year Treasury Yield Spread

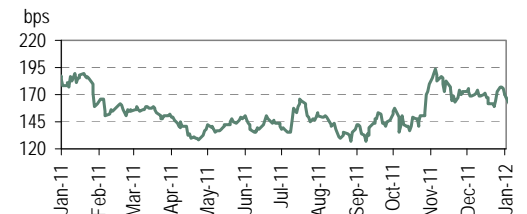
US	Change in Level (bp)			
	Current	1wk	MTD	YTD
Fed	0.25	0	0	0
3 Mo	0.05	1	4	4
2 Yr	0.21	-3	-3	-3
5 Yr	0.75	-14	-8	-8
10 Yr	1.89	-13	1	1
30 Yr	3.06	-4	16	16
2 - Fed	-0.04	-3	-3	-3
5 - 2	0.54	-11	-6	-6
10 - 5	1.14	0	10	10
30 - 10	1.17	9	15	15



Source: Bloomberg

2- to 10-Year Bund Yield Spread

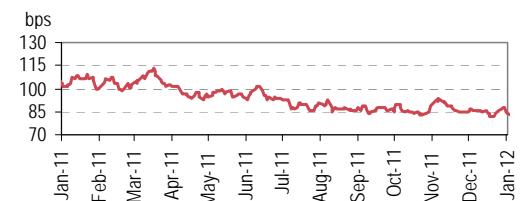
Europe	Change in Level (bp)			
	Current	1wk	MTD	YTD
ECB	1.00	0	0	0
1 Yr	0.11	3	18	18
2 Yr	0.19	-2	5	5
5 Yr	0.81	-8	5	5
10 Yr	1.86	-7	3	3
30 Yr	2.54	-1	17	17
2 - ECB	-0.81	-2	5	5
5 - 2	0.62	-6	1	1
10 - 5	1.05	1	-3	-3
30 - 10	0.68	6	14	14



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	0.11	-1	0	0
2 Yr	0.13	0	-1	-1
5 Yr	0.33	-1	-2	-2
10 Yr	0.97	-2	-2	-2
20 Yr	1.74	-2	-2	-2
30 Yr	1.94	-1	1	1
2 - BOJ	0.03	0	-1	-1
5 - 2	0.20	-1	-1	-1
10 - 5	0.64	-1	-1	-1
30 - 10	0.97	1	3	3



Source: Bloomberg

Market Review: Emerging Markets

Emerging markets (EM) fixed income rallied this week as risk aversion abated. The JP Morgan Emerging Markets Bond Index (EMBI) Global gained 1.01%, and spreads tightened three basis points over the week. EM currencies appreciated across the board with the Hungarian forint, Polish zloty and Russian ruble leading the total return while the Argentine peso and Indonesian rupiah lagged. The JP Morgan Corporate Broad EMBI Composite Index increased by 1%, with the high-yield component outperforming the investment grade. EM assets registered US\$4.4 billion of inflows in the week up to January 25. Bond funds recorded inflows of approximately US\$900 million, and equity funds registered inflows of US\$3.5 billion.

JP Morgan Emerging Markets Bond Index Global



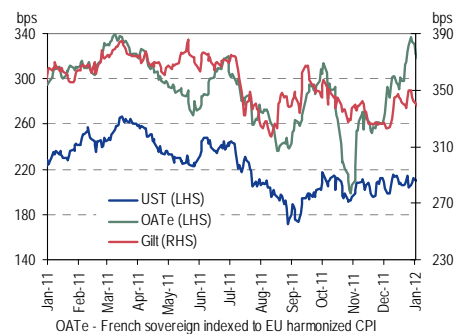
Source: Bloomberg

Market Review: Global Inflation-Linked Bonds

In the United States, the FOMC surprised markets by lengthening the period over which it expects rates to remain on hold from mid-2013 to "at least late 2014". Treasury prices rallied, driving real and nominal yields lower. At the same time, the easier policy stance encouraged breakeven inflation (BEI) rates to widen, with the July 2021 BEI rate pushing as wide as 2.28% intra-week. The five-year sector performed even better, though, with investors noting how much breakevens in the sector were marked below the Federal Reserve's 2.0% PCE target. Meanwhile, the 10s/30s BEI differential continued to cheapen in anticipation of 30-year supply in February.

In the euro area, front-dated BTPeIs managed to recoup some ground following a well-received €500 million BTPei (due September 2014) auction, and probably assisted by confidence instilled by the European Central Bank (ECB) long-term refinancing operation (LTRO). Investors were then faced with sovereign ratings downgrades on five countries by Fitch on Friday. Italy was downgraded to A-, taking the issuer closer to possible expulsion from widely-followed indices including the Barclays Capital inflation-linked debt indices.

GILBs - 10-Year Breakeven Spreads



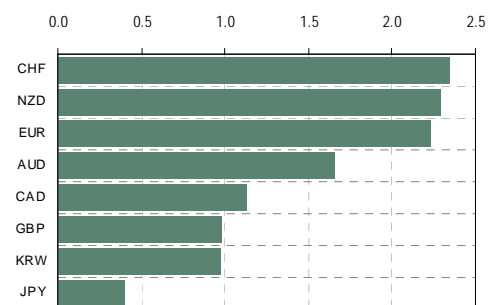
Source: Bloomberg, performance in percentage points (%)

Market Review: Currency Markets

G10

For the week, the US dollar was the worst performer followed by the Japanese yen. The euro rallied more than 2% on the week and is now up against the US dollar for the year. Despite the uncertainty in the ongoing Greece PSI (Private Sector Initiative) negotiations, the market was buoyed by the lack of negative news out of Europe. The recent improvement in European fundamentals has led investors to unwind some of their pessimism (i.e., short euro positions). Moreover, the extremely short euro positions have triggered waves of short-covering after the release of a dovish US Federal Reserve statement. Chairman Bernanke has extended the Federal Reserve's commitment to low policy rates through 2014, which was a major surprise given the recently better US data. As the Federal Reserve continued to embark on an easy monetary policy, EM currencies and cyclical currencies were the best performers for the week.

US Dollar's WTD Performance Against Other Majors

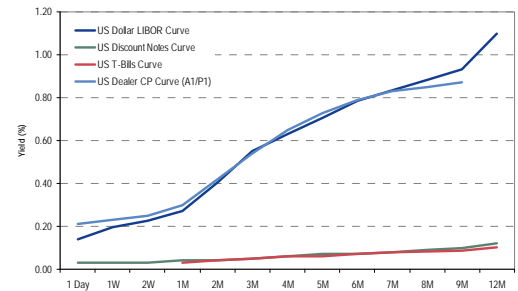


Source: Bloomberg, performance in percentage points (%)

Market Review: Money Markets

The focus for the week was the FOMC meeting and what its new communication transparency would reveal. Citing significant concerns about downside risks to the economic outlook and little concern about inflation, the Federal Reserve extended the “lower for longer” mantra, signaling rates would remain low “at least through late 2014”. On cue, the fourth quarter GDP came in lower than expected at 2.8% versus a range of 3%–3.3%. From the euro area, attention was focused on the negotiations for agreement on Greek debt. S&P followed up its downgrade of France last week with the downgrade of four French banks, but changed its outlook to stable. With this behind them, several banks were able to regain access to the short-term markets and issue debt.

Money Market Yield Curves



Source: Bloomberg

Market Review: Spread Sectors

Sector Rotation: Corporate Credit

US and European corporate bonds outperformed government bonds for the sixth consecutive week. The ECB LTRO continues to drive liquidity into the markets. US economic data was mixed, but the FOMC was the main event. The Federal Reserve announced the first rate increase would be no sooner than late 2014 and indicated lower hurdles to further quantitative easing (QE3). High-grade bonds had US\$1.4 billion of inflows, up from US\$844 million last week. High-yield bonds had US\$1.9 billion of inflows versus US\$1.3 billion last week. US corporate bonds delivered +0.60% excess return over Treasuries for the period and closed the week at 207 basis points (-10 basis points). European corporate bonds outperformed government bonds by +1.01% and ended the week at 279 basis points (-21 basis points).

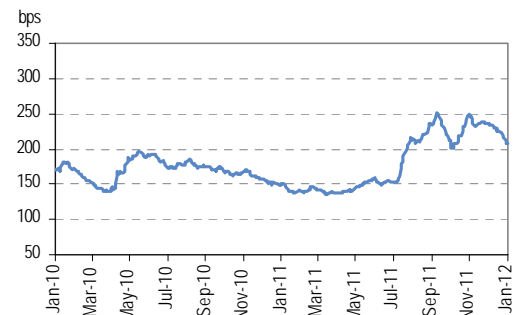
Mortgage-Backed Securities

The mortgage sector underperformed duration-matched Treasuries by seven basis points this week. Positive performance in the lower coupons was offset by weak performance in the higher coupons. Refinancing indicators moved higher, and both President Obama and HUD Secretary Shaun Donovan spoke about trying to expand (even further) refinancing efforts, causing high coupons to underperform. With the Federal Reserve continuing to reinvest paydowns and maturities in MBS and keeping short interest rates low, MBS offered a very strong technical outlook. We remain positive on structured products, including MBS, CMBS and non-agency RMBS.

Asset-Backed Securities

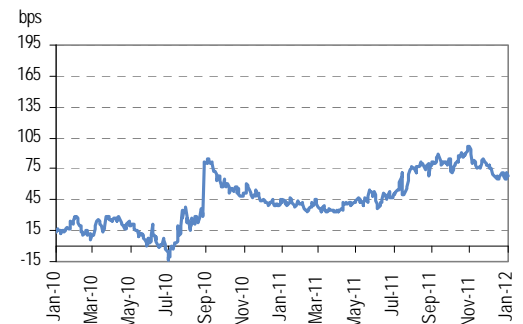
ABS volume was muted this week as many investors and counterparties attended the American Securitization Forum (ASF) 2012 Conference in the first half of the week, where the tone was bullish for spread products. One new deal priced this week—a fixed, seven-year GE card deal at swaps+70 basis points. Consumer ABS spreads remained relatively unchanged with two-year credit card spreads at swaps+8 basis points, two-year prime autos at swaps+17 basis points, and three-year student loans at LIBOR+50 basis points.

Investment-Grade Corporate Bond Index OAS



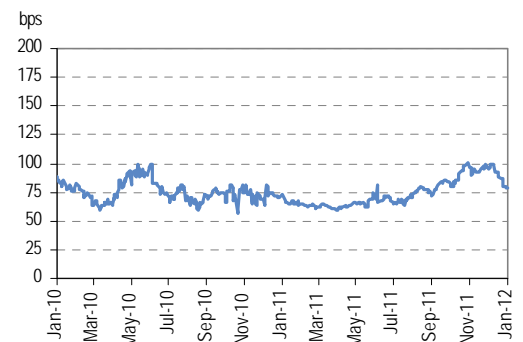
Source: Barclays Capital

Agency MBS Current-Coupon Fixed-Rate OAS



Source: Barclays Capital

Barclays Capital ABS Index OAS



Source: Barclays Capital

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